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THE SAFETY AND SOUNDNESS OF GOVERNMENT SPONSORED ENTERPRISES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

TO

INVESTIGATE THE POTENTIAL EXPOSURE OF THE FEDERAL GOVERNMENT TO LIABILITY BECAUSE OF IMPLICIT GUARANTEES FOR GOVERNMENT SPONSORED ENTERPRISES

OCTOBER 31, 1989

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THE SAFETY AND SOUNDNESS OF GOVERNMENT-SPONSORED ENTERPRISES

TUESDAY, OCTOBER 31, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, D'Amato, Garn, Heinz, and Wirth.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Our scheduled first witness, Under Secretary for Finance at the Department of the Treasury, Robert Glauber, is detained at the Ways and Means Committee this morning, and will be here somewhat later. So we are going to start.

I am going to invite as our first witness Mr. Thomas Gillis, who is the Managing Director of Standard and Poor's Corporation. Let me have you take a seat. I have an opening statement that I am going to make, and then we will call on you.

Our hearing this morning is on the subject of Government-sponsored enterprises. As some of you would know, in the thrift legislation enacted last August, Treasury was given responsibility for a very important study of the safety and soundness of what are termed GSE's; namely, Government-sponsored enterprises. That is a study that Treasury publicly recommended be undertaken, so we put it into the law. By the same token, the General Accounting Office was given a similar task.

Now, the results of those two very important studies are not due until next May, but we hope to hear today what the Treasury's concerns were when they made the recommendation, how they plan to proceed, what work has been done, and what is their view of the proper role and effectiveness of these Government-sponsored enterprises.

Now, some of these institutions have served to substantially alter the way financial markets work, increasing their efficiency and helping to channel funds to areas of critical need such as education and housing. But while many have friendly and comforting names, like "Sallie" and "Freddie" and "Fannie" and "Connie" and so forth, here are some facts that make me uncomfortable.

These institutions, first, are very large. They currently have $800 billion in debt outstanding, and that is an amount which has doubled in just 4 years. $800 billion is about equal to the deposits of our 25 largest money center and regional banks, and it is about 85 percent of all savings and loan deposits.

It is generally believed that, like bank and thrift deposits, these securities will be backed by the Government if and when that were necessary. Despite that, by law or by custom, some GSE's are apparently almost immune from government regulation or examination of their safety and soundness.

Under this regime, many GSE's have chosen to leverage themselves in a big way. Collectively, their equity represents only about 3 percent of their total capitalization, and excluding the Federal Home Loan Banks their equity capital ratio is less than half as much— about 1¼ percent. That is a very small amount. The clearly under-capitalized S&L industry has as much, and large banks with an average 5 percent equity ratio have much more.

We need to find out if there are special reasons which justify these low capital ratios and whether taxpayers are in fact adequately protected. We need to know if we have a properly designed system of supervision and regulation, and if not what would one look like. We need to learn whether the administration is doing all that it can do and should do under current law to safeguard taxpayers in this area.

Having just gone through the experience of providing hundreds of billions of dollars to protect S&L depositors, the need for careful oversight where government guarantees are concerned is overwhelmingly apparent. And while I doubt that anyone would suggest that we currently face problems with Government-sponsored enterprises anything like those involving the thrift industry, we have seen how important it is, when necessary, to try to act to prevent losses and not just react to them after they have occurred.

So in addition to these critical safety and soundness issues, we will also want to consider what the collective impact of these agencies is. How do they affect credit flows in their more purely private financial market competitors? To what extent do the benefits flow to the borrowers they were designed to help, and to what extent are they captured by investors?

So we begin that process today by hearing in due course from the Treasury Department, when Mr. Glauber is able to join us, and also hearing from three other outside witnesses, all of whom bring certain expert knowledge to this issue and can help fill in some of these areas of information for us.

With that, let me yield to Senator D'Amato.

Senator D'AMATO. Well, Mr. Chairman, let me commend you for holding these hearings. I think it is important to get the kind of information that you made reference to. I am going to ask that my statement be included in the record as if read in its entirety.

The CHAIRMAN. Very good.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I join you in welcoming today's witnesses and commend you for taking this time to investigate the potential exposure of the Federal Government to liability because of implicit guarantees for Government-sponsored enterprises.

I will observe that this issue can be seen one of several ways or, properly, as a matrix of issues. The extent of the government's exposure is based on the strength of the implied guarantee. Looking at the GSE issue this way, one may say that elimination of the implicit guarantee is the answer provided that the private sector will serve the function.

However, the strength of the government's guarantee is a function of how well the GSE performs the function for which it was established. And the quality of the GSE's performance probably depends upon the degree of the government's commitment which correlates directly to the strength of the government guarantee.

While this description of the issue may sound circular I think it is a way of reminding the committee that this is not a clear issue of reducing governmental exposure but one of managing that exposure and getting the kind of performance out of Government-sponsored enterprises that we should demand.

So I appreciate the work that has gone into these hearings and I look forward to a productive and realistic discussion of the many GSE issues.

The **CHAIRMAN**. Senator Dixon.

Senator **DIXON**. Thank you, Mr. Chairman.

I will put my statement in the record as well. I commend you on this hearing as well.

The **CHAIRMAN**. Thank you very much.

STATEMENT OF SENATOR ALAN DIXON

Senator **DIXON**. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee begins its investigation of Government-sponsored enterprises. I look forward to the testimony from Under Secretary of the Treasury Robert Glauber and from the panel of financial experts from New York and Washington.

I support strongly all of the goals which Government-sponsored enterprises were created to serve: making housing more affordable for average working Americans; assuring the availability of student loans to those who aspire to further their education; providing credit to farmers' cooperatives.

I also support strongly asking questions about the Government-sponsored enterprises which are pursuing these goals. What are the risks of loss to the Federal Treasury? Are there adequate safeguards and proper incentives to minimize these risks? How accurately can we measure the potential cost of these off-balance-sheet liabilities? How can we quantify the benefits which the public is actually receiving? Are the current benefits greater than the costs? Who is actually benefitting from the GSE activities?

I hope our witnesses today will provide some answers and ask additional questions. It is important that the studies of GSE's due this coming May from both the Treasury Department and the General Accounting Office focus on the right questions—and provide honest answers.

The **CHAIRMAN**. Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman.

I would ask unanimous consent that my statement be placed in the record.

The CHAIRMAN. Without objection, it is so ordered.

I also have a statement from Senator Sasser that will be inserted in the record.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Mr. Chairman, today's hearing will focus on Government-sponsored entities [GSE's]. These organizations were created by Congress in order to increase the flow of credit to particular segments of the economy. Among the beneficiaries are first time home buyers, farmers and students.

GSE's accomplish this goal through various means. For example, some GSE's purchase eligible loans written by private lenders, package these loans into pools, and then issue securities representing interests in these pools to the investing public. GSE's may also purchase loans and hold them in portfolio, issuing debt securities to fund these purchases. While the securities issued by GSE's are not explicitly backed by the Government, the close association of these congressionally created enterprises with the Government has resulted in a perception in the market that the Government stands behind these instruments. Thus, GSE's generally have the ability to borrow at near U.S. Treasury interest rates.

In recent years there has been a proliferation of GSE's. Further, the amount of securities issued by the established GSE's has dramatically increased. The total outstanding amount of debt issued by the five largest enterprises is approximately $720 billion, and may reach the $800 billion level by the end of FY90.

These statistics demonstrate that Congress must maintain careful oversight over Government-sponsored enterprises. It is important that we consider the nature and adequacy of Federal supervision over the activities of these organizations, their effect on the capital markets, the relationship to other Government borrowings, and their effect on private sector competitors.

While we conduct this oversight function, it is important to remember that the GSE's were all established by the Congress to serve important public purposes. The success of the GSE's in fulfilling these public purposes should also be examined.

In this regard it may be noted that some contend that GSE's serve only the well-to-do. However, the facts do not bear this out. For example, the average home loan purchased by Fannie Mae in 1988 was only $69,000, 30 percent of all mortgages purchased by Fannie were for amounts of less than $40,000. The average home loan purchased by Freddie Mac is that year was only $68,500, and 32 percent of mortgages purchased by Freedie Mac were less than $40,000. These numbers seem low when compared to the new FHA loan limit of $125,000 [or 95 percent of median area home price] that we recently passed on the Senate floor. Student loans eligible for purchase by Sallie Mae cannot be made to families with gross income in excess of $30,000, and 40 percent of all student loans are made to students attending technical or trade schools, not 4 year universities.

In my mind the bottomline questions are these: Are GSE's adequately achieving the goals Congress established when they were created? Are GSE's operating in a safe and sound manner with appropriate levels of capital and Government surpervision? And are GSE's activities creating market distortions that interfere with other governmental programs or private sector activities?

Thank you, Mr. Chairman, and I am looking forward to hearing today's witnesses.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I'd like to complement you on calling this important hearing. In the aftermath of the savings and loan bailout, it's imperative that Congress not leave any stone unturned in making sure that such a situation cannot develop again.

Personally, I don't believe that the Government-sponsored enterprises [GSE's] pose the same kind of a risk to the taxpayers as did the savings and loans—but we have to be sure. I guess we have to follow the adage: "Once bitten, twice shy."

The GSE's are off-budget entities but they are quasi-governmental creatures. As such there is a potential contingent liability, but it's hard to quantify—it may be negligible.

There are no insurance funds for these entities, so if they run into trouble, all that stands between them and the taxpayers is their own capital base. And there are questions about the capital adequacy of the GSE's.

So I think we need to make a careful examination. These GSE's are all different. They have different missions, the public purposes of which must be considered. GSE's have been or enormous assistance in standardizing a secondary market for home mortgages, and thereby reducing interest rates for homebuyers. Other GSE's like Sallie Mae, have had beneficial effects.

So Mr. Chairman, I thank you again for calling this hearing, and look forward to the testimony of the witnesses.

The CHAIRMAN. Mr. Gillis, you are the managing director of the Standard and Poor's Corporation, and you have taken a look at these agencies, and you have submitted a statement to us. I would like you, if you would now, to summarize your testimony. We will make the full statement a part of the record. We would like your expert view on this.

STATEMENT OF THOMAS GILLIS, MANAGING DIRECTOR, STANDARD AND POOR'S CORP., NEW YORK

Mr. GILLIS. Thank you, Mr. Chairman and members of the committee.

Frank Rizzo, who you invited to testify, is ill, and asked me to extend his sincere apology.

You have asked us to discuss how Standard and Poor's evaluates the implicit government support for certain Government-sponsored enterprises, as well as what those entities' credit worthiness would be without that government support.

S&P has maintained Triple-A assessments on the securities of the Farm Credit System, Fannie Mae, Freddie Mac, and Sallie Mae, since 1983. Triple-A represents Standard and Poor's highest quality assessment. The Federal Home Loan Bank's consolidated notes and bonds were added in 1986. All credit evaluations for these GSE's are based on the government's implicit support.

During the past few years, financial difficulties of FSLIC and the Farm Credit System have heightened the market's concern about those entities' ability to meet their financial obligations.

The Congress, however, despite huge budget deficits, has addressed the financial needs of these entities which do not have the full faith and credit of the United States Government. Therefore, Standard and Poor's continues to consider the debt of these entities as eligible investments for Triple-A rated financings.

Standard and Poor's completely reviews a congressionally authorized agency or corporation before adding it to the Triple-A qualified investment list or assigning a rating. Four major factors are analyzed: Legislation, links to the Federal Government, the impact of service, and the business fundamentals.

Importantly, Standard and Poor's assesses the willingness of the Federal Government to provide support. Such support is critical to creditworthiness. Links to the U.S. Government and its implied backing provide the credit strength that leads to a higher rating.

These criteria describe our analysis of the potential risk to an investor in the securities of one of these government-sponsored enterprises.

You have also asked us to evaluate the potential risk to the government of several of these government-sponsored enterprises without the consideration of the implicit government support. We have done our analysis using public information, and so it can only be considered a preliminary assessment.

The CHAIRMAN. Before you get into this, which is important, I would like you to pull the microphone just a little bit closer so the people in the back of the room are able to hear you clearly. Thank you.

Mr. GILLIS. Certainly.

There are risks in certain operational standards which cannot be determined by a review of the public financial statements. An indepth review of underwriting and servicing standards, for example, demonstrates the quality control within a corporation. This in turn provides insight into the company's ability to service debt and security holders in a distressed economic environment.

In the remainder of my statement, I will be using the terms "investment grade" and "non-investment grade." Issues rated in the four highest rating categories are generally called investment grade. These issues have from an extremely strong to an adequate capacity to pay interest and repay principal. Non-investment grade debt is rated in lower categories. These issues will likely have some quality and protective characteristics, but will be subject to uncertainties and major exposure to adverse conditions. Some of the characteristics which lead to our opinion for both investment grade and non-investment grade will be discussed in our statement.

The first enterprise I would like to discuss is Fannie Mae. Fannie Mae has two major business lines. It purchases residential mortgage loans for its own portfolio, and it issues guaranteed mortgage backed securities. The mortgage backed securities business has grown rapidly since 1981, when Fannie Mae issued its first issue; while the portfolio business has been relatively flat.

Profitability has improved over the past few years, reflecting increased guarantee fees and improved asset quality. Capitalization is low, at $3 billion of equity and reserves as of June 30, 1989.

Our preliminary assessment of the risk to the Government for senior debt would be at least investment grade.

The Federal Home Loan Mortgage Corporation, or Freddie Mac——

The CHAIRMAN. Now, when you say "at least investment grade," it sort of noses over the line, but you are not making a statement as to how far over the line into investment grade it gets?

Mr. GILLIS. That is correct, Mr. Chairman.

The CHAIRMAN. Is that because it just makes it into that category?

Mr. GILLIS. Well, from our analysis, we believe that it would be in one of the lower investment grade rated categories. We do not want to fine tune that grade without doing further research.

The CHAIRMAN. I see. So they are in the investment grade at the low end of the scale?

Mr. GILLIS. That is correct.

The CHAIRMAN. All right. Very good. Let's go to the next one.

Mr. GILLIS. The next one is Freddie Mac, which primarily purchases single family conventional mortgages and subsequently sells them in the form of guaranteed mortgage backed securities.

Freddie Mac is most similar in scope and structure to a mortgage insurer or a financial guarantee company. Good underwriting and quality control are indicated by lower delinquencies and foreclosures than reported by the mortgage banking industry and the mortgage insurance industry. Operational results for the past five years have been sound, with returns on average in excess of 20 percent.

However, Freddie Mac is highly leveraged, resulting in low capitalization. Our preliminary assessment of the risk to the Government for the senior debt would be at least investment grade.

Now, if I may take a moment to further describe the differences in risk between Fannie Mae and Freddie Mac, both Fannie Mae and Freddie Mac have credit risk in their guarantee business. Fannie Mae, with its portfolio, is also exposed to interest rate risk and funding risk in that it has to constantly go into the market to refund its debt that supports that portfolio. Therefore, we feel it is important to note that Fannie Mae's business lines have inherently greater risk than that of Freddie Mac.

The next enterprise is the Federal Home Loan Banks. The Federal Home Loan Banks raise funds in the public market to lend to member thrifts by providing secured advances. The system has historically been very profitable, with a return on average assets of 1 percent. FIRREA requires the Federal Home Loan Banks to contribute some $2.5 billion in retained earnings and $300 million per year to help the thrift insurance fund.

There is no reason at this time that these provisions should significantly impair the Federal Home Loan Banks' capital. Our qualified rating assessment for senior debt would be at the high end of the investment grade scale.

The Farm Credit System. The Farm Credit System is a nationwide system of lending institutions that provide long-term, secured loans on farm properties and short- and intermediate-term loans on an unsecured basis. Given its concentration in agricultural lending, system results are heavily dependent on the cycles in the farm economy.

Results in the mid-1980s were very poor. Over the past several years, things have improved somewhat. Equity, in which we include the $4 billion of U.S. Treasury guaranteed debt provided by the 1987 legislation, is high, but could still be higher, given the risk in the farm economy. Going forward, the new insurance fund should add to the stability of the system.

Our preliminary assessment of the risk to the Government for the senior debt would be at the high end of the non-investment grade category.

Sallie Mae purchases and holds student loans for its own portfolio, and provides warehouse financing to student lenders on a collateralized basis. It also maintains a sizeable investment portfolio. Sallie Mae has had consistently high profitability, at about 90 basis points of earning assets. Equity equaled 2.63 percent as of June.

Our preliminary assessment of the risk to the Government for the senior debt would be at the high end of the investment grade categories.

The CHAIRMAN. I am sorry, say that again? The high end of the investment grade?

Mr. GILLIS. That is right.

The CHAIRMAN. All right. Very good.

Mr. GILLIS. Once again, Mr. Chairman and members of the committee, I must stress that we have done an analysis using public information only, so that it can only be considered a preliminary assessment. There are certain risks to certain operational standards which cannot be determined by a review of the public financial statements.

I would like to conclude by saying again that Standard and Poor's believes the debt of all the government-sponsored enterprises to be Triple-A quality, based upon the implicit government support.

We hope that this information has been of help to you, and I would be happy to answer any questions.

[The complete statement of Thomas Gillis follows:]

Statement of Frank Rizzo to the
Senate Banking Committee
October 31,1989

Mr. Chairman and Members of the Committee, my name is Frank Rizzo and I am a Managing Director of the Debt Rating Division of Standard & Poor's Corporation. You have asked us to discuss how Standard & Poor's evaluates implicit government support for certain Government Sponsored Enterprises (GSE's) and how we would view the credit of these GSE's without the implicit support of the U.S. government. I am happy to be here today to discuss these subjects.

Standard & Poor's has maintained an assessment of 'AAA' on the securities of the Farm Credit System, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Student Loan Marketing Association (Sallie Mae), since 1983. 'AAA' represents Standard & Poor's highest quality assessment. This assessment enables Trustees of 'AAA' rated debt to invest in the securities of these GSE's. The Federal Home Loan Banks (FHLBanks) Consolidated Notes and Bonds were added in 1986. All are assessed based on their links to the U.S. government and implicit government support.

During the past few years, financial difficulties at some U.S. agencies and corporations created by federal legislation heightened market concern about their ability to meet financial obligations. Two prominent examples are the Federal Savings & Loan Insurance Corp. (FSLIC) and the Farm Credit System. However, despite the federal government's huge budget deficit, Congress so far has addressed the financial needs of these entities, which do not have the full faith and credit backing of the U.S. Therefore, Standard & Poor's continues to consider the debt of these entities as eligible investments for 'AAA' rated financings.

Standard & Poor's completely reviews a Congressionally authorized agency or corporation before adding it to the 'AAA' qualified investment list or assigning a rating. Four major factors are analyzed: legislation, links to the federal government, impact of the service, and business fundamentals. Importantly, Standard & Poor's assesses the willingness and ability of the federal government to provide support. Such support is critical to creditworthiness. Links to the U.S. government and its implied backing provide the credit strength that leads to a higher rating.

Congress' creation of the agency/corporation is a statement that a public purpose is being served. The authorizing legislation and the conference report, especially for newer GSE's, provide additional insight into purpose, the service provided, and the method of providing it. For GSE's which have existed for some time all amendments are reviewed. When financial assistance is provided in the legislation, it can take differing forms. Support can be:

--Direct financial, as in a line of credit with the U.S. Treasury or annual Congressional appropriations.

--Indirect financial, as in the ability to issue debt exempt from Securities & Exchange Commission (SEC) registration, eligibility for fiduciary, trust and public funds whose investment is under U.S. government control, and generally favored treatment in the securities markets. These benefits along with any others listed in the authorizing legislation characterize "agency status," which allows access to the capital markets at yields below comparable high grade corporate debt.

Ongoing federal support for an agency/corporation can be shown in differing ways - through annual appropriations from Congress or the ability to borrow from the Federal Financing Bank. For example, Congress authorized the issuance of U.S. guaranteed debt through the Financial Assistance Corporation to aid the troubled Farm Credit System.

Standard & Poor's also looks for the agency/corporation to operate with prudent business practices, providing its service as efficiently as possible within its public purpose. An analysis of financial statements, business lines, and policies is extremely important. These factors determine whether any financial support from the U.S. government may be needed, the nature of the support, and willingness of Congress or the Executive branch to provide it.

Authorizing legislation provides information on business flexibility. Unlike private companies, Congressionally chartered agencies/corporations are restricted to specified business lines. Therefore, Standard & Poor's examines initial legislation and amendments up to the time of the rating review, because such changes may enhance or diminish the business strength of the agency/corporation.

This criteria describes our analysis of the potential risk to an investor in securities issued by one of these GSE's. Standard & Poor's evaluates other agencies/corporations established by Congress under this criteria. The securities of the Financing Corporation (FICO) and the Tennessee Valley Authority (TVA) fall under this analysis. A complete description of our criteria and a brief write-up on the agencies/corporations are attached at the end of this statement.

You have also asked us to evaluate the potential risk to the government of several of these GSE's without consideration to the implicit government support. We have done our analysis using public information only and so it could only be considered a preliminary assessment. There are risks to certain operational standards which cannot be determined by a review of public financial statements. An in depth review of underwriting standards and servicing standards, for example, demonstrates the quality control within the corporation. This in turn provides insight into the company's ability to service debt and security holders in a distressed economic environment.

In the remainder of my statement I will be using the terms investment grade and non-investment grade. Issues rated in the four highest rating categories are generally called investment grade. These issues have from extremely strong to adequate capacity to pay interest and repay principal. Non-investment grade debt is rated in lower categories. These issues will likely have some quality and protective characteristics, but will also be subject to uncertainties or major exposure to adverse conditions. Some of the characteristics which lead to our opinion for both investment grade and non-investment grade will be discussed in the text.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

Outstanding Debt as of 6/30/89: $106 billion
Outstanding MBS as of 6/30/89: $196 billion

Fannie Mae has two major business lines. It purchases residential mortgage loans for its own portfolio and it issues guaranteed mortgage-backed securities (MBS). The MBS business has grown rapidly since 1981 when Fannie Mae did the first issue, while the portfolio business has been relatively flat. Profitability has improved over the past few years reflecting increased guarantee fees and improved asset quality. In addition, Fannie Mae has reduced its exposure to interest rate risk with a GAP position today of almost 0% on a maturity basis and a duration gap of 8 months. In 1985, underwriting standards were tightened. Delinquent loans were down to .8% on 5/31/89 from 1.4% at the end of 1986. Charge off experience has improved as well. Capitalization is low at $3 billion equity and reserves as of 6/30/89, but is growing slowly. Our preliminary assessment of the risk to the government for senior debt would be at least investment grade. A full rating analysis would include a review of the credit of the originators who have sold mortgages to Fannie Mae where Fannie Mae has the recourse. We would also have to be comfortable with Fannie Mae's operating systems and review the negotiated transactions, since these tend to involve higher risk.

FEDERAL HOME LOAN MORTGAGE CORPORATION

Outstanding Debt as of 6/30/89: $18 billion
Outstanding PC's and GMC's as of 6/30/89: $245 billion

Freddie Mac primarily purchases single family conventional mortgages and subsequently sells them in the form of guaranteed mortgage-backed securities. Freddie Mac is most similar in scope and structure to a mortgage insurer/financial guarantee company. Over 95% of Freddie Mac's servicing portfolio was financed with mortgage-backed pass-through securities. Financing in this way minimizes Freddie Mac's interest rate risk. Operational results of the past five years have been sound with returns on average equity in excess of 20%. These returns primarily reflect the tremendous growth in mortgage-backed securities. Good underwriting and quality control are indicated by lower delinquencies and foreclosures than reported by the mortgage banking and mortgage insurance industries. However, Freddie Mac is highly leveraged, resulting in low capitalization. Our preliminary assessment of the risk to the government for senior debt would be at least investment grade. A full rating analysis would include a complete analysis of the characteristics of the mortgages to test Freddie Mac's capital and resources against losses resulting from a "worst case" simulated depression.

FEDERAL HOME LOAN BANKS

Outstanding Debt as of 6/30/89: $154 billion

The FHLBanks raise funds in the public market to lend to member thrifts by providing secured advances. The system has historically been very profitable with a return on assets at 1.0%. Since many thrifts have difficulty accessing the capital markets, the FHLBanks become a major source of funds. Asset quality has traditionally been very good. Each FHLBank sets its own collateral levels with higher levels for lesser quality collateral. While there might have been some concern about exposure to the FSLIC since some banks accepted FSLIC notes and guarantees as collateral, provisions in the FIRRE Act have substantially mitigated this concern. Authorizing legislation mandates outstanding obligations to capital at 12:1. The FIRRE Act requires the FHLBanks to contribute some $2.5 billion in retained earnings and $300 million per year to help the thrift insurance fund. There is no reason at this time to think that these provisions will significantly impair the FHLBanks' capital. Our qualified rating assessment for senior debt would be at the high end of the investment grade scale. Standard & Poor's has current 'AAA' ratings on letter of credit obligations for most of the twelve banks. A full rating analysis would include a review of those which do not have ratings currently.

FARM CREDIT SYSTEM

Outstanding Debt as of 6/30/89: $53 billion

The Farm Credit System is a nationwide system of lending institutions that provide long term loans secured by farm properties, and short and intermediate term loans on an unsecured basis. Given its concentration in agricultural lending, system results are heavily dependent on cycles in the farm economy. Results in the mid-1980's were very poor. Over the past several years, things have improved somewhat. Annualized return on assets based on income as of 6/30/89 was 1.04%. While this is attractive, the figure is driven by reversing the provision for loan losses. Adjusting for this reversal, return on assets would be .40%. Although reversal of loan loss provisions is consistent with GAAP accounting, it is rarely done by private sector financial institutions. Nonetheless, profitability is improving at the Farm Credit System. Asset quality has shown an improving trend although levels are still very high and loan loss coverage is not very strong. High risk loans and foreclosed property were 15.7% at 6/30/89, down from 24.05% at the end of 1986. Reserve to high risk loans was 23.1% at 6/30/89. A deterioration in asset quality could lead to a need to boost reserves. Equity, while high, could be higher given the risk in the assets, especially with the cyclical nature of the farm economy. Legislation in 1987 provided for up to $4 billion of U.S. Treasury guaranteed debt issued by the Financial Assistance Corporation to assist the Farm Credit System. This provides stability for the system. Going forward, the new insurance fund should add to the stability of the system. Our preliminary assessment of the risk to the government for senior debt would be at the high end of the non-investment grade range. A full rating analysis would include an understanding of underwriting guidelines, loan administration and collection procedures at the levels where the loans are actually made. We would also need to examine in detail a sampling of problem and performing credits.

STUDENT LOAN MARKETING ASSOCIATION
Outstanding Debt as of 6/30/89: $29 billion

Sallie Mae purchases and holds student loans for its own portfolio and provides warehouse financing to student loan lenders on a collateralized basis. It also maintains a sizeable investment portfolio. Sallie Mae has had consistently high profitability, at about .90% of earning assets. The assets, student loans, are guaranteed by the U.S. government and thus are of the highest quality. Warehouse loans are collateralized and investments are of generally high quality. Although earnings retention has been strong, the combination of asset growth and the buyback of common stock has led to increased leverage in recent years. Equity to assets has decreased from 2.99% at the end of 1987 to 2.63% as of June 1989. Our prelminary assessment of the risk to the government for senior debt would be at the high end of the investment grade range. A full rating analysis would include an in-depth review of servicing operations and a complete examination of the warehouse lending with attention to the types and levels of collateral accepted by Sallie Mae and the credit strength of the client base.

I would like to conclude by saying again that Standard & Poor's believes the debt of all these GSE's to be 'AAA' quality based on the implicit support of the U.S. government. We hope the information we provided today is helpful to the Committee. I will be happy to answer any questions.

Agencies with implied U.S. support

During the past few years, financial difficulties at some U.S. agencies and corporations created by federal legislation heightened market concern about their ability to meet financial obligations. Two prominent examples are the Federal Savings & Loan Insurance Corp. (FSLIC) and the Farm Credit System. However, despite the federal government's huge budget deficit, Congress so far has addressed the financial needs of these entities, which do not have the full faith and credit backing of the U.S. Therefore, S&P continues to consider the debt of these entities as eligible investments for 'AAA' rated financings *(see list)*.

S&P completely reviews a Congressionally authorized agency or corporation before adding it to the 'AAA' qualified investment list or assigning a rating. Four major factors are analyzed: legislation, links to the federal government, impact of the service, and business fundamentals. Importantly, S&P assesses the willingness and ability of the federal government to provide support. Such support is critical to creditworthiness. On a standalone basis, many Congressionally authorized agencies and corporations would not be investment grade. Thus, links to the U.S. government and its implied backing provide the credit strength that leads to a higher rating.

In addition, debt with the full faith and credit support of the U.S. government is considered to be 'AAA'. The U.S. Treasury falls in this category. The Government National Mortgage Association (GNMA) and the U.S. Maritime Administration guarantee the debt of other issuers. That guarantee, in turn, is backed by the full faith and credit of the U.S. S&P allows such full faith and credit obligations as 'AAA' qualified investments without reviewing the debt security or the issuer. *For an analysis of the United States, see page 56.*

Legislation

Authorizing legislation for an agency or corporation is reviewed thoroughly. If the entity is newly created, the Congressional/legislative conference report provides legislative history and background on the importance of the service. Any differing views between the House of Representatives and the Senate are studied. The conference report can provide insight into the new entity's purpose, the service provided, and the method of providing it.

If the entity has existed for some time, the authorizing legislation and all amendments are studied. Business lines or operations may be adjusted over time, making a review of amendments critical for a full understanding. S&P also may review:

—Related legislation. Some agency/corporations receive appropriations or are subject to the budget process each year.

—Oversight hearings and reports by the General Accounting Office or the Congressional Budget Office. The research reports can provide additional perspective.

Finally, S&P prefers to meet with members or staff of the Congressional committee with jurisdiction over an agency/corporation. This provides a clearer understanding of the legislative process, current legislative initiatives, and the relationship between the entity and Congress.

Federally authorized agencies/corporations

	'AAA' assessments
Farm Credit System	Investments
FHLBank System	Investments
Federal Home Loan Mortgage Corp.	Investments
Federal National Mortgage Assn.	Investments Obligor
Financing Corp. (FICO)	Investments
Student Loan Marketing Assn.	Investments Obligor
Tennessee Valley Authority (TVA)	Investments Obligor Senior debt

Investments means the obligations issued by that entity are qualified as investments for 'AAA' rated debt.

Obligor means the entity provides credit enhancement for a debt issue.

Senior debt means direct issuance.

Impact of the service

The type of service provided by the agency/corporation is analyzed. One factor considered is the extent and effect of the private sector's ability to provide the same service. Privatization of services now covered through federal legislation continues to be discussed.

The effect a default or loss of service would have at the national level in the public and private sectors helps define essen-

(continued on next page)

tiality. Congress' commitment to depositors in federally insured financial institutions is an example. Because the safety and security of insured deposits is essential to the national financial system, Congress passed a resolution in 1982 stating its belief that deposits in federally insured institutions are secure up to the specified amount. This resolution was reaffirmed in 1987.

Historical statements or examples of federal commitment are important. For example, legislation assisting the Farm Credit System in 1985 and 1987 showed that Congress is ready to stand behind that entity. If such statements were lacking, the political atmosphere in the Executive and Legislative branches would be evaluated.

Links to the federal government

Congress' creation of the agency/corporation is a statement that a public purpose is being served. When financial assistance is provided in the legislation, it can take differing forms. Support can be:

—*Direct financial*, as in a line of credit with the U.S. Treasury or annual Congressional appropriations.

—*Indirect financial*, as in the ability to issue debt exempt from Securities & Exchange Commission (SEC) registration, eligibility for fiduciary, trust and public funds whose investment is under U.S. government control, and generally favored treatment in the securities markets. These benefits along with any others listed in the authorizing legislation characterize "agency status," which allows access to the capital markets at yields below comparable high grade corporate debt.

Ongoing federal support for an agency/corporation can be shown through annual appropriations from Congress, the ability to issue debt backed by the full faith and credit of the U.S., and the ability to borrow from the Federal Financing Bank. A review of historical appropriation requests and actual funding is essential in this respect. For example, Congress authorized the issuance of U.S. guaranteed debt through the Financial Assistance Corp. to aid the troubled Farm Credit System.

Links to the U.S. government and demonstrations of support for each entity can be viewed on a scale of strength, timeliness, and discretionary authority. At one end of the spectrum the backing of the full faith and credit of the U.S. is the strong assurance that principal and interest will be paid. At the opposite end is the need for legislative authorization before financial support is forthcoming. The vast majority of agencies/corporations S&P evaluates fall in between.

Business

On a stand-alone basis, many agencies/corporations are financially weak. However, Congress established these entities for a public purpose and the federal government has since supported them. Thus, while the business plans, operations, and financial position are analyzed, the ratings or assessments are based on the support of the Legislative and Executive branches and the essentiality of the service.

S&P also looks for the agency/corporation to operate with prudent business practices, providing its service as efficiently as possible within its public purpose. An analysis of financial statements, business lines, and policies is extremely important. These factors determine whether any financial support from the U.S. government may be needed, the nature of the support, and willingness of Congress or the Executive branch to provide it.

Authorizing legislation provides information on business flexibility. Unlike private companies, Congressionally chartered agencies/corporations are restricted to specified business lines. Therefore, S&P examines initial legislation and amendments up to the time of the rating review, because such changes may enhance or diminish the strength of the agency/corporation.

Another key element is competition. Congress usually creates an agency/corporation to provide a service not available from the private sector. However, competition from the private sector may develop over time. This is what has happened in the residential mortgage secondary market.

The enormous interest in privatization has made it an essential analytical element. Any attempts by the Executive and/or Legislative branches to reduce support and privatize the agency/corporation are reviewed. In some instances, the Executive branch has recommended privatization, but Congress has rejected it. This implies continued Congressional support for the agency/corporation.

The weaker the agency/corporation on stand-alone financial terms, the stronger the government support tends to be. As an agency/corporation becomes a stronger business, links to the federal government may be curtailed. Because the analysis depends so heavily on these links, any weakening could result in a rating downgrade even though the agency/corporation is becoming stronger on its own.

After a thorough review of documentation, S&P usually meets with management. The meeting provides a detailed understanding of the agency/corporation's business and policies and the ties to the federal government. It also allows the agency/corporation to gain a thorough understanding of S&P's rating process.

Surveillance

Ongoing analysis and surveillance of the agency/corporation is designed to pick up financial problems and any potential need for financial assistance from the federal government. In addition, surveillance is designed to monitor new policies, legislative changes that could change the business line or structure of the agency/corporation, and attempts for privatization. This gives insight into the government's ongoing willingness to provide support.

The following briefly describes the seven entities whose securities are qualified investments for 'AAA' rated debt or whose debt is rated 'AAA'. Together, these entities had over $700 billion of debt and mortgage-backed securities outstanding as of Dec. 31, 1988.

Farm Credit System (FCS) is changing and consolidating. The U.S. Congress originally established FCS in the early part of the 1900s as the Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives. Congress brought the three entities together under FCS in 1971. Held by a network of borrower-owned banks and associations, it provides loans to finance residential and agricultural land, farm equipment, and rural utilities. The Farm Credit Administration, an independent regulatory agency of the U.S. government, regulates FCS.

During the past few years, severe financial problems have plagued the system. Legislation passed in December 1987, which authorized the issuance of up to $4 billion of U.S. guaranteed debt by the Financial Assistance Corp. to aid the Farm Credit System, illustrates strong Congressional support. The legislation also mandated a consolidation of the banks. As part of that consolidation, the Federal Land Banks and Federal Intermediate Credit Banks were merged into 12 district Farm Credit Banks last July.

FCS obtains funds primarily by issuing debt in the form of consolidated obligations, which are the joint and several liability of system banks and have "agency status" in the capital markets. As of Dec. 31, 1988, there were approximately $39.5 billion in consolidated bonds and $14.4 billion in consolidated notes outstanding.

Federal Home Loan Bank System (FHLBanks) was established by Congress in 1932 through the Federal Home Loan Bank Act to provide a stable supply of mortgage credit to member thrifts. The FHLBanks are owned by their members, but supervised by the Federal Home Loan Bank Board (FHLBB). Each of the 12 district banks is governed by its own board of directors, which is responsible for establishing operating standards and policies to manage exposure to credit, liquidity, and interest rate risk. FHLBank consolidated notes and bonds serve as a major source of funds. They are issued on behalf of the district banks by the Office of Finance in Washington, D.C. The Secretary of the Treasury must approve public security offerings. Consolidated obligations, which are joint and several obligations of all the FHLBanks, must not exceed 12 times the total of system banks' paid-in capital stock and reserves The banks are required to maintain assets in amounts equal to outstanding debt Congress has authorized the Secretary of Treasury to purchase up to $4 billion of FHLBank obligations

Congress currently is working on legislation to assist the ailing U S thrift industry This legislation should provide no financial risk to the FHLBanks' consolidated debt obligations S&P's assessment of the FHLBanks takes into consideration its links to the U S government, which includes "agency status" for its systemwide securities As of Dec 31, 1988, the FHLBanks had approximately $20 9 billion in consolidated notes and $115 6 billion in consolidated bonds outstanding

Federal Home Loan Mortgage Corp (FHLMC) was authorized by Congress in 1970 as Title III of the Emergency Home Finance Act It provides liquidity in the residential mortgage market by purchasing conventional mortgages The three FHLBB members, who are appointed by the U S President, serve as FHLMC's board of directors Congress currently is considering legislation to provide for an 18-member board of directors which, if adopted, would replace the current three-member board FHLMC is authorized to issue nonvoting common and preferred stock The 12 FHLBanks own the common stock, and thrift institutions, which are members of the FHLBank system, hold the preferred In July 1988, the board agreed in principle to allow participating preferred stock to be sold to the public in 1989

Since 1970, Congress has amended Freddie Mac's original legislation several times For example, in 1984 Congress gave FHLMC the authority to purchase second mortgages Also in 1984, Congress eliminated FHLMC's exemption from paying federal income taxes effective Jan 1, 1985 These examples illustrate Congress' continuing interest in the business and operations of entities it creates FHLMC does not have direct access to U S Treasury funds However, the Treasury Secretary can purchase up to $4 billion of FHLBank obligations and these funds can be advanced to FHLMC

To fund the purchase of residential mortgages, FHLMC principally issues several mortgage securities, especially participation certificates, guaranteed mortgage certificates, and collateralized mortgage obligations (CMOs) It holds few mortgages in portfolio, preferring to issue mortgage-backed securities to raise funds As of Dec 31, 1988, FHLMC had approximately $20 1 billion of long- and short-term debt and $226 4 billion in mortgage participation and guaranteed mortgage certificates outstanding

Federal National Mortgage Association (FNMA) was created by the National Housing Act in 1938 to provide liquidity for lenders through the purchase of Federal Housing Administration (FHA) insured mortgages In 1968, the Government National Mortgage Association (GNMA) was spun off and FNMA was transferred to private ownership FNMA is now a federally chartered, stockholder-owned corporation Congress expanded its authority in 1970 to purchase conventional mortgages, which today account for the majority of FNMA's purchases In 1984, Congress gave FNMA authority to purchase second mortgages

A board of directors made up of five members appointed by the U S President and 13 members elected by the stockholders governs FNMA The Secretary of Housing & Urban Development has general regulatory powers, including the authority to require that a reasonable portion of FNMA's mortgage purchases assist low- and moderate-income families The Secretary of the Treasury may purchase up to $2 25 billion of FNMA securities

FNMA funds itself through a variety of debt instruments In addition, FNMA has issued mortgage-backed securities since 1981 These securities have "agency status" in the capital markets As of Dec 31, 1988, FNMA had approximately $105 billion of long- and short-term debt and $178 2 billion mortgage-backed securities outstanding

Financing Corp (FICO) was authorized in August 1987 as Title III of the Competitive Equality Banking Act to recapitalize the Federal Savings & Loan Insurance Corp (FSLIC) through the issuance of up to $10 8 billion in debt FICO is governed by a three-member directorate composed of Federal Home Loan Bank officials and is authorized to

—issue debt in the capital markets
—issue nonvoting capital stock to FHLBanks
—invest in securities issued by FSLIC

FICO securities have the same agency status as FHLBank consolidated notes and bonds FICO's debt is not an obligation of or guaranteed by FHLBanks, the U S, or FSLIC The issues are 30-year noncallable securities Principal is secured by U S Treasuries, which match the maturities of FICO's bonds The Treasuries are purchased with FHLBank funds when FICO bonds are issued, and are held in a segregated account at the Federal Reserve Bank of New York Current coupon interest on the bonds is payable from assessments to the thrift industry

S&P's assessment of FICO debt is based on its ties to the U S government and the government's support of FSLIC and insured deposits evidenced by the creation of FICO Legislation now being considered by Congress should have no adverse effects on FICO's debt obligations As of Dec 31, 1988, FICO had $5 8 billion in bonds outstanding

Student Loan Marketing Association (SLMA) was created by Congress in 1972 in amendments to the Higher Education Act of 1965 SLMA provides a secondary market for U S guaranteed student loans For the first decade, SLMA obtained its funding through the Federal Financing Bank Since 1982, it has financed its activities primarily through debt issued in the capital markets Over the years Congress has expanded SLMA's authority to include servicing of student loans, making secured loans to state and nonprofit institutions to fund student loan operations, and financing capital improvements of colleges and universities SLMA is a stockholder-owned corporation governed by a 21-member board of directors composed of seven representatives of colleges and universities that hold voting stock, seven representatives of financial institutions that hold voting stock, and seven members appointed by the U S President, who also appoints the chairman of the board

Links to the U S Government are illustrated in many ways, starting with SLMA's establishment and continuing with amendments to expand its business activities The Secretary of the Treasury may purchase up to $1 billion of SLMA securities This provides a potential line of credit to SLMA, although it never has used this option

SLMA funds its operations primarily by issuing debt in the capital markets Debt obligations must be approved by the Secretary of the Treasury As of Dec 31, 1988, SLMA had approximately $26 8 billion long- and short-term debt outstanding

Tennessee Valley Authority (TVA) was created by Congress in the Tennessee Valley Authority Act of 1933 to develop the Tennessee River system and to assist in the development of other resources in the Tennessee Valley and adjoining areas Today, TVA supplies power at wholesale prices to municipalities and cooperative distributors which in turn distribute power to customers in Tennessee, northern Alabama, northeastern Mississippi, southwest Kentucky, and small parts of Georgia, North Carolina, and Virginia TVA is a corporation wholly owned by the U S and is governed by a board of directors which is appointed by the President and confirmed by the Senate for nine-year terms

TVA is authorized to issue debt in the public markets, but has not issued senior debt since 1974 Today TVA funds itself through borrowings from the Federal Financing Bank TVA's legislation authorizes borrowings up to $30 billion While TVA's debt is not backed by the full faith and credit of the U S, there are strong links to the federal government The strongest and most important is the ability to borrow from the Federal Financing Bank

As of Dec 31, 1988, TVA had only $1 4 billion of debt outstanding in the public market All public debt issues will have matured by Jan 1, 1999

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CreditComment

Securitizing farm loans

The U.S. Congress is aiding the securitization of farm mortgages with the creation of the Federal Agricultural Mortgage Corp. (Farmer Mac). The move is an effort to establish a secondary market for agricultural real estate mortgage loans. While an estimated $90 billion in farm mortgages are outstanding, no national secondary market for these assets exists. Farmer Mac is authorized to guarantee debt service on securities collateralized by farm loans and issued by an approved financial institution or corporation. While Farmer Mac is in its infancy, it has broad potential. But it should establish strong issuer and pool guidelines for success.

The legislation, part of the Agricultural Credit Act of 1987, provides for a 15-member board of directors consisting of some elected by common stockholders and some appointed by the U.S. President. A temporary board is in the process of raising $20 million of initial capital and, when completed, the permanent board will be established.

Farmer Mac will then develop standards for issuer certification and define characteristics for eligible pools of mortgage loans. Farmer Mac will, in effect, establish national standards much like the Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) did for conventional single-family loans in the early 1970s. The legislation presents minimum criteria for issuers, including meeting capital standards established by the board, demonstrating ability to underwrite and service agricultural mortgages and to adopt underwriting, appraisal, and servicing standards set by the board for farm mortgages. Each mortgage pool must show geographic dispersion, varied principal amounts, a wide variety of crop production where the land is used for farming, and include no less than 50 mortgages.

Numerous other guidelines are part of the legislation. These points, taken together, will determine each mortgage pool's quality and performance. Obviously, the better the pool performs the less chance reserves will be used or that Farmer Mac would have to pay investors in accordance with its guarantee when reserves are depleted.

Diversity of farm mortgages

One major issue is the lack of standardization in agricultural mortgages. Single-family residential mortgages tend to be underwritten along Fannie Mae/Freddie Mac guidelines. There are no national standards for agricultural mortgages. Use of consistent underwriting standards eliminates the need to look at each mortgage loan in a pool individually. Another issue is the potential link between agricultural performance and ability to pay the mortgage loan. For example, a single-family homeowner may change jobs or have other income adjustments that may not affect ability to make mortgage payments. However, agricultural mortgage payments are more vulnerable to factors such as government subsidies and farm production.

Other issues may affect pool performance. Diversity of crops, loan size, whether the mortgaged property is an owner or tenant farm, and geographic dispersion are key factors. These factors should be considered both individually and as to their relative importance to the pool.

Once issuer, pool, and loan requirements are established, Farmer Mac will provide a guarantee on securities issued by approved entities, including commercial banks, insurance companies and Farm Credit System banks. Guarantee conditions should be examined. For example, Farmer Mac can only provide the guarantee if a reserve is held for at least 10% of the outstanding principal amount of loans. In addition, the legislation states that Farmer Mac should "ensure the timely receipt of principal and interest due to security ... holders only after full recourse has been taken against such reserves ...." As specific guidelines are developed, guarantee terms should be reviewed carefully to assess payment timing if the guarantee is used, and the flow of funds should be checked to ensure timely payment to security holders.

The legislation authorizes the Secretary of Treasury to purchase up to $1.5 billion of Farmer Mac obligations after certification that all pool reserves and Farmer Mac reserves have been depleted. This provides a strong link to the federal government and creates the opportunity for a national secondary market for agriculture mortgages where none existed. However, as Farmer Mac grows and provides guarantees which exceed the financial assistance, it will be vitally important to have strong issuer and pool guidelines.

No guidelines exist as yet for certifying issuers or pools, but a potential market is there. While the agricultural industry has had major problems, land prices still have risen. Partially because of the drought this summer, it may be too early to predict a recovery, but there is cautious optimism for the future.

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Rating Analysis

Connie Lee Insurance Co.
Rating 'AAA'

Date of report: 8/1/89
S&P contacts:
John Chyriwski (212) 208-1596
Joan Pickett (212) 208-1818

Holding company: College Construction Loan Insurance Association
Holding company owners: Student Loan Marketing Association
U. S. Dept. of Education

Domicile: Wisconsin.
Licensed: 42 states and D.C.
Other ratings: None.

Rationale: Connie Lee Insurance Co.'s (Connie Lee) claims-paying ability is rated 'AAA'. The rating reflects: an initial capital position consisting of $59.5 million paid-in capital and a $25 million capital commitment from the Student Loan Marketing Association (Sallie Mae), which supports growth and provides adequate coverage to withstand a worst-case loss scenario that factors in the effects of the comparatively narrow business focus; a senior management team and underwriting staff with expertise in financial guaranty insurance, investment banking, finance, and education; strong and supportive ownership consisting of Sallie Mae and the U.S. Dept. of Education; and the expectation, supported by established underwriting guidelines and policy, that Connie Lee will continue to develop an investment grade quality risk portfolio. Over time, S&P expects that Connie Lee will develop a wide diversity of credits by geographic region, legal structure, use of proceeds, and primary insurers within its specialized market sector. The 'AAA' rating has been assigned on the basis that Connie Lee will operate solely as a reinsurer. S&P has been advised that Connie Lee will seek to become a primary insurer in the future. In that event, the rating will be reevaluated.

Selected statistics

	Connie Lee Insurance Co.	
	—Year ended Dec. 31—	
(Mil. $)	**1989***	**1988**
Aggregate net exposure	1,200.0	117.4
Gross premiums written	8.8	1.0
Net premiums written	8.8	1.0
Net premiums earned	0.2	0.0
Net income (loss)	(3.2)	(3.9)
Cash and invested assets	61.7	56.4
Unearned premium reserve	9.6	1.0
Policyholders' surplus	53.3	56.5
Statutory capital	53.8	56.5

*As of 6/30

Business review: Connie Lee is an operating insurance company owned by the College Construction Loan Insurance Association, an insurance holding company authorized by Congress and established as a private corporation under the laws of the District of Columbia. Connie Lee's legislated mission is to provide facilities-financing support for higher education by insuring and reinsuring the industry's debt obligations. "Higher education" includes colleges, universities, and teaching hospitals.

In its role as a reinsurer, Connie Lee provides this support by effectively increasing the capacity of the primary insurers to insure issues in the higher education and teaching hospital sectors of the market. In addition, Connie Lee expects to develop new financing programs where it can participate as a reinsurer. In this manner, it can expand the breadth and scope of available credit enhancements and perhaps make credit enhancements available to certain segments of the market previously not served.

As of June 30, 1989, reinsurance arrangements with Municipal Bond Investors Assurance (MBIA) and Bond Investors Guaranty Insurance Co. (BIG) had been completed that generated $9.8 million in written premium and $1.2 billion of aggregate exposure, which represents Connie Lee's total exposure. In addition to the assumption of previously written business, which accounts for 72% of exposure, both arrangements contain provisions for treaties that are proportional in nature, with the BIG arrangement also providing for facultative coverage. As of June 30, BIG represents 66% of aggregate exposure, with MBA accounting for the remaining 34%.

Ownership: College Construction Loan Insurance Association is capitalized entirely with common stock, of which 75.2% is held by Sallie Mae and the balance by the U.S. Dept. of Education. An investment of $59.5 million has been made in the common stock of Connie Lee, forming its capital base. In addition, Sallie Mae has committed to provide an additional $25 million of capital should Connie Lee require it. This commitment expires on Dec. 31, 1997. Sallie Mae has already provided considerable nonfinancial support, such as executive, staff, and facilities resources to Connie Lee, and as the largest shareholder, can be expected to continue to provide support. The U.S. Dept. of Education, while not obligated to provide future financial support, is solidly committed to this venture and its *raison d'etre*.

Management: Senior management of Connie Lee has considerable experience in the fields of higher education, healthcare, financial guaranties, finance, and investment banking. Several key executives, including the president, were formerly with Sallie Mae. The head of underwriting and the chief financial officer were formerly with Financial Guaranty Insurance Co. The general counsel was previously with AMBAC Indemnity Corp. Senior management consists of a president and chief executive officer, general counsel, chief financial officer, and senior vice presidents of underwriting and reinsurance. The current staff numbers 26.

Connie Lee's board of directors operates through several committees including finance, executive, audit, and underwriting. Board membership is composed of representatives or appointees of the two shareholders, and includes senior executives from the financial and educational communities.

Underwriting: As a specialized credit enhancement company, Connie Lee is organized to review education and teaching hospital credits. The company has established underwriting guidelines, policies, and procedures that are designed to produce an investment grade book of business. To date, it has completed underwriting reviews on a substantial portion of all bonds it has ultimately reinsured. It evaluates the primary insurer's underwriting capabilities and selectively reviews specific transactions. To date, Connie Lee has only reinsured issues underwritten by insurers who themselves are subject to the same investment grade underwriting standards. The current underwriting staff consists of six professionals.

Financial performance: Connie Lee started business in December 1988 and completed only one reinsurance agreement prior to year-end. This produced $1.0 million of written premium and $117.4 million of aggregate exposure. Because of the late start, no premium was earned during the year. With no earned premiums and limited time to earn investment income, total expenses exceeded revenues resulting in a statutory loss of $3.9 million. It is not uncommon for start-up financial guaranty companies to show losses in their early years until a substantial book of business and investment portfolio can be established.

The investment portfolio is invested in a mix of high-grade taxable securities. No investments in common stocks are planned. A portion of funds may be invested in short-term instruments. At June 30, 1989, the portfolio broke down as 99% taxable and 1% tax-exempt. 18% of the portfolio was in short-term investments, and the overall average life of the portfolio was 4.5 years.

Reinsurance: Connie Lee has no present plans to retrocede any of its risk to other reinsurers.

Capital: To determine capital adequacy, Connie Lee's projected portfolio was subjected to a worst-case scenario assumed to begin in 1994. Appropriate capital charges were applied to the portfolio to determine the losses that could be expected during the four-year worst-case period. Substantial growth in new business was assumed through 1993. Given the higher risk associated with the comparatively narrow business focus of higher education and related healthcare, net results indicated a satisfactory cushion of capital available in excess of expected claims. The availability of the $25 million capital commitment from Sallie Mae was a significant factor in Connie Lee demonstrating satisfactory capital adequacy.

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The **Chairman**. Let me just first of all acknowledge the presence of Senator Heinz. Senator Heinz, did you have any initial comments you wanted to make?

Senator **Heinz**. Mr. Chairman, no. I would just ask unanimous consent that my statement be included in the record, and observe on this Halloween occasion that this hearing is most appropriate, as you look at the government-sponsored enterprises. The title of this hearing might be properly "Trick or Treat."

I look forward to hearing from our witnesses in that regard. Thank you.

[The complete prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR JOHN HEINZ

Senator **Heinz**. Mr. Chairman, I join you welcoming today's witnesses as this committee examines the operations and financial condition of Government-sponsored enterprises. It seems fitting that we schedule this hearing on Halloween. The specter of a potential Government bailout of GSE's with more than $700 billion of debt is enough to frighten any Member of Congress.

GSE's are creatures of Congress assembled with parts taken from both the public and private sectors. GSE's have public charters—but private owners. Their boards of directors have both Government appointed and privately elected members. GSE's serve the policy goals of Government—but receive no direct Government funding. The fusing of public and private sectors into a single entity creates issues that haunt some observers of GSE's.

Of course the greatest fear is that GSE's are Government agencies masquerading as private enterprise. These observers note that GSE's can raise debt at favorable rates that defy their underlying financial condition. They worry that the public sees visions of Government guarantees that are not visible to the naked eye. These observers seek to unmask the risks that arise from this implicit Government guarantee. They are spooked by what they see.

Mr. Chairman, it is a treat to have such a distinguished group of witnesses to discuss this bewitching subject. I warn them in advance that today I may be tempted to ask at least one trick question.

The **Chairman**. Do you feel, does Standard and Poor's feel that it has enough information and has examined this set of questions closely enough to feel that steps might properly be taken by the Government to strengthen any of these areas from the point of view of their credit strength and their credit risk?

Mr. **Gillis**. I am not sure if I understand.

The **Chairman**. In other words, I am wondering if you are able to reach a professional judgment that causes you to say that probably some additional efforts at strengthening one or more of these ought to take place, in order to reduce the risk and create a stronger structure and credit position.

Mr. **Gillis**. Okay. Well, Mr. Chairman, that really is a decision that we feel is up to the Government, in that the amount of risk that is acceptable depends on the Government's tolerance for that risk. The stronger the credits of these enterprises, the more an offsetting argument there is about their usefulness as far as public purpose. The more conservatively they operate, the less public purpose I would imagine they would serve.

The CHAIRMAN. Now, I want to go through two or three other things with you. In terms of going down through your assessment of each of the agencies that you have mentioned, you have said today in terms of risk to the Government that one of these agencies would fall below investment grade. Two years ago you told HUD that another one, which has since improved a bit, was a "BB" rated credit. Of course, those are junk bond ratings.

In effect, what you are saying is that the Government is and has been guaranteeing, in effect, junk bonds, or less than investment grade, in this area. There are different labels put upon them. But wouldn't that be one way of describing what we have been doing here?

Mr. GILLIS. That could be one way of describing it, yes, Mr. Chairman.

The CHAIRMAN. Now, you mentioned that the management quality of some of these agencies are factors which would help them get high ratings. How confident can we be that the management quality will continue indefinitely? How do you size that up?

Suppose we get new managers that are less skillful? Would that open us up to a potentially substantial increase in the risk?

Mr. GILLIS. Yes, Mr. Chairman, we believe so. We think that management and the quality of management are important indicators in future performance.

The CHAIRMAN. You have also said you are relying on publicly available information. How good does the quality of available information appear to be, compared to totally private firms?

Mr. GILLIS. I would say, Mr. Chairman, that it is roughly on par with private firms, that we have been happy with the public information. However, with our private company ratings, we do meet with companies and go through a thorough review of their operations.

The CHAIRMAN. Is there anything that you have not found in the way of information that perhaps should be available, that would help not just you as an outside rating service but anyone else to assess the strength, credit position, and credit worthiness, of one of these organizations?

Mr. GILLIS. If I may, Mr. Chairman, I would like to get back to you on that, if I could submit our answer.

The CHAIRMAN. Fine.

Mr. GILLIS. That is a fairly involved question.

The CHAIRMAN. Fine.

Now, the GSEs have public debt of about the same magnitude as those of all of our money center banks put together. Most of those banks have ratings of "A" or above, but some of the largest GSEs you described only as "at least investment grade." That was the phrase you used, and as I asked you about it, they made it into that category but they are at the very low end of the range. Yet, there is an enormous amount of money represented there, and in a sense a potential exposure.

Is it likely then that, ignoring government guarantees, if you weighted them by size, money center banks would have a higher credit rating on average than GSE's? Is that a fair statement?

Mr. GILLIS. It may be. I am not as familiar with the relative asset sizes of the two.

The CHAIRMAN. Well, apparently they are about on a par. If you take the large money center banks in total, and the regional banks with them, they add up to a total amount of asset strength about the size of the GSE's. So they are roughly the same size here.

But it seems to me that what is happening here is that, if you take out the government guarantee, which by itself is obviously a very important factor, but from the point of view of risk—assessing the risk and preventing the risk and not wanting to have some disaster hit us down the road—it would seem that we would want to have capital in place that is roughly equal to what we find in the banking system. Yet, we are finding it substantially lower than that.

Isn't that a matter of some concern?

Mr. GILLIS. Again, Senator, it depends upon the Government's tolerance for that risk. I mean, ultimately you have to match up the level of risk to whatever the economic environments are that you would expect those entities to be able to withstand.

I would like to mention that our lower-end investment grade scales we feel do represent safety; that holders will be paid. It is a very good rating.

The CHAIRMAN. Although in a sense, if a rating is to change—and ratings do change——

Mr. GILLIS. Yes.

The CHAIRMAN [continuing]. And so it does not take much of a change then if they are sliding backward, to slide backward into the next category which is more adverse. Is that not also true?

Mr. GILLIS. That is true.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Although we know that government-sponsored enterprises are not backed by the Government, certainly the perception is there that they will, and we in other areas have certainly followed through with that perception. We have come to the assistance of various quasi-governmental agencies.

What would be the economic and market effects if the Government severed this implicit relationship to GSE's?

Mr. GILLIS. I would imagine, Senator Garn, that there would be major impacts. Being at Standard and Poor's, we are not expert in the secondary market conditions. Our focus is credit quality. So I am not really qualified to answer that question.

Senator GARN. Well, being qualified to answer questions before Congress has never been a requirement——[Laughter.]

Senator GARN [continuing]. Of coming before a hearing.

In light of the benefits conferred on GSE's through their relationship with the Government and the implicit backing we have talked about, do you feel that federal oversight and regulation of GSE's is sufficient?

Mr. GILLIS. Well, Senator, it depends upon the Government's tolerance for risk. Triple-B, single-A, has a certain strong level of credit quality associated with it. Depending upon what type of mouse trap one wants to build, that will really determine whether or not there is enough oversight right now, or not.

Senator **GARN**. No, he is qualified to respond to Congressional inquiries. [Laughter.]

With that answer, you could run for public office. [Laughter.]

I have no further questions. I see Mr. Glauber is here.

The **CHAIRMAN**. Well, let me thank you and thank Standard and Poor's for their work in this area. After we have heard from Mr. Glauber, we will move on to our other outside witnesses that we have invited today. But let me thank you for your testimony. We may have some other questions for you for the record.

Mr. **GILLIS**. All right. Thank you, Mr. Chairman. Thank you, Senator Garn.

The **CHAIRMAN**. Thank you very much, Mr. Gillis.

Let me now call Robert Glauber forward. He is the Under Secretary for Finance of the Department of the Treasury. We welcome the Under Secretary here this morning. I know he had a conflict over on the House side, and I trust that all items have been resolved that relate to the Finance and Ways and Means Committee and he can so state before we start here today.

We are very interested in your testimony this morning. We are particularly interested in the fact that the Treasury Department asked in the FIRREA legislation, the savings and loan reform legislation, that we undertake a very careful and systematic evaluation and review of the strength and the circumstances of each of the government-sponsored enterprises.

We have incorporated that of course in the legislation. It is now the law, and that work is underway, presumably, because it is due in in the spring of next year. We are very much interested in hearing from you today as to what it was that may have been matters of concern sufficient to cause the Treasury to ask that that be included, and what procedures and effort are now underway, and whatever other light you feel you can shed on this at this stage of the game.

STATEMENT OF ROBERT R. GLAUBER, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. **GLAUBER**. Let me begin, Mr. Chairman, by saying that the Under Secretary comes before you with great embarrassment for his lateness, and extends to you his apologies. I was delayed in the Ways and Means hearing room. I believe that they informed you that I might be late.

The **CHAIRMAN**. Yes, they did, and we understand that, and we appreciate the difficulty of trying to be in two places at once. We are just pleased to have you here now.

Mr. **GLAUBER**. I am indeed delighted to be here, and happy today to participate in this hearing on government-sponsored enterprises and to discuss the GSE studies which Treasury will perform, as required under FIRREA.

At the outset, let me say that we share your interest in GSE's, particularly with regard to the risk of taxpayer loss which they pose, their financial condition, and the adequacy of their current capital positions.

As you may recall, Assistant Secretary Mullins, in his April 18 testimony before House Ways and Means, recommended that a federal entity be asked to study the relationship between risks and GSE capital, and to consider whether capital standards should be established for GSE's. Indeed, that is our request to which you made reference. Thus, we are pleased that GAO will be conducting studies on capital requirements for GSE's, and we welcome the opportunity to perform Treasury studies to assess the financial safety and soundness of GSE's and the impact of their operations on federal borrowing.

Over the years, Treasury has been involved in a number of policy initiatives designed to control the growth and cost of federal and federally-assisted credit. The Federal Government is the largest financial intermediary in the United States. At the end of fiscal year 1988, the Government held $222 billion of outstanding direct loans, including $124 billion financed by the Federal Financing Bank, and had another $550 billion in outstanding guaranteed loans, including $451 billion of FHA and VA mortgages and $48 billion of guaranteed student loans.

Government-sponsored enterprises such as Fannie Mae and the Farm Credit Banks had an additional $666 billion of outstanding loans at the end of the year, approximately $615 billion in the housing area and $51 billion in the agricultural sector. Thus, directly or indirectly, the Government had influenced the allocation of $1.4 trillion of outstanding credit to farmers, home owners, small businesses, exporters, utilities, ship builders, and state, local, and foreign governments.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally assisted borrowing in the form of off-budget guaranteed loans and borrowing by off-budget government-sponsored enterprises. Yet, of the estimated $209 billion of net federal and federally-assisted borrowing in fiscal year 1990, including the $4.5 billion of REFCORP bonds auctioned on October 25, but excluding prospective REFCORP borrowing, 49 percent is for financing the budget deficit, 15 percent for financing off-budget federal loan guarantee programs, and 36 percent for financing off-budget GSE's.

Taken together, it is clear that off-budget credit assistance from the Federal Government will be the largest component of total borrowing under federal auspices in this fiscal year.

The CHAIRMAN. I might just say at that point that that is a pretty powerful paragraph you have just delivered there, I think, in terms of the magnitude and I think probably the growth rates, too, which you may be planning to elaborate on. They are an important part of this story in terms of the increase in these debt levels. Please continue.

Mr. GLAUBER. I certainly agree with that, sir.

FIRREA requires that the Secretary of the Treasury conduct two annual studies of the following eight GSE's:

The Federal National Mortgage Association, Fannie Mae, created in 1938 as a government-owned corporation to provide a secondary market for federally guaranteed home mortgages. Fannie Mae became private in 1968, and since 1970 has been a major purchaser of conventional mortgages as well.

The Federal Home Loan Mortgage Corporation, Freddie Mac, created in 1970 to provide a secondary market for conventional mortgages.

The Federal Home Loan Bank System, created in 1932 to provide liquidity for the thrift industry.

The Farm Credit Banks, created in 1987 when the Federal Intermediate Credit Banks and the Federal Land Banks were merged. The banks provide credit assistance for agricultural purposes.

Banks for Cooperatives, created in 1933 to finance the operations of farmers' cooperatives. All but two of these banks were merged in 1988 into a single National Bank for Cooperatives.

Farmer Mac, the Federal Agricultural Mortgage Corporation, created two years ago to shift the financing of farm loans from the bank loan market to the securities market.

The Student Loan Marketing Association, Sallie Mae, created in 1972 to provide liquidity to lenders involved in the guaranteed student loan program.

The College Construction Loan Insurance Association, Connie Lee, created in 1986 to guarantee and insure bonds and loans issued and made for the construction and renovation of college and university facilities.

The table attached to my testimony provides aggregate data on borrowing activities of the GSE's. Under FIRREA, the Secretary may also designate other GSE's to be included in the studies. However, given the limited resources which we have to devote to these studies, we may well limit the studies to these eight GSE's I have just listed.

With the exception of Connie Lee, the GSE's are privately-owned entities, but are distinguished from fully private financial intermediaries by their close favored relationship with the Federal Government. For example, GSE's generally have special tax exemptions, their obligations are eligible for open market purchase by the Federal Reserve, and with the exception of securities issued or guaranteed by Farmer Mac and securities guaranteed by Connie Lee, they are exempt from SEC registration.

GSE's typically have authority to borrow limited amounts from the U.S. Treasury, which helps to reinforce the market perception of an implicit federal guarantee of their outstanding debt, allowing them to borrow at interest rates lower than those available to fully private firms.

The value to the GSE of the Government's implicit guarantee depends largely on the operating policies adopted by the individual GSE. For a fully private firm, its borrowing costs are positively related to the market's perception of the risks that the firm undertakes and its activities. The implicit government guarantee of agency debt, however, weakens the relationship between a GSE's cost of funds and the risks it assumes. The larger the gap between a GSE's actual cost of money and the cost it would have to pay if the Government were not seen as absorbing the risk of default, the greater the value of the implicit guarantee. Thus, GSE's have an incentive, at least structurally and conceptually, to take more risks, which could increase the taxpayers' exposure to potential loss.

Our two studies of GSE activities will, where possible, quantify the risks associated with each of the eight GSE's to be studied. In quantifying the risks, we will, as required under FIRREA, determine the volume and type of securities outstanding which are issued or guaranteed by each GSE; the capitalization of each GSE; and the degree of risk involved in the operation of each GSE due to such factors as credit risk, interest rate risk, management and operation risk, and business risk.

In addition, we will report on the quality and timeliness of information currently available to the public and the Government concerning the extent and nature of GSE activities, and the financial risks associated with such activities. We will also examine the growth and nature of GSE borrowing in the market, to which you have just alluded, Mr. Chairman, and assess its impact on federal and federally-assisted borrowing.

Although we are in the early, formative stages of the initial study, we have made considerable progress in establishing a broad set of issues for the study. As described above, FIRREA has clearly defined the parameters of the studies.

Since the nature of a GSE's business and the operating policies of its management determine the risk exposure to the taxpayer, it is necessary to analyze each GSE separately. We have therefore decided to adopt a case study approach, under which direct and indirect costs posed by the activities of each individual GSE will be studied in-depth. The case study approach will allow us to apply a common framework of analysis to each GSE, while recognizing that each GSE operates in a unique manner and a unique environment.

The studies will require the cooperation of various federal agencies and all the GSE's. We have already held several meetings with GAO staff which will be involved in conducting their study. While the focus of the GAO study is different from the focus of ours, we have agreed to coordinate our data collection efforts.

Over the past three months, we have collected various data which will be needed for the studies. We have also met with several GSE's. The GSE's which we have contacted to date have been very cooperative. In addition, we have talked to the private sector firms which may be of some help to us in analyzing the business and management risks posed by various GSE activities.

As you can see, our work on the studies has begun. Given the recent experience with the savings and loan crisis and the magnitude of the GSE financial activities, we believe that the proposed studies of GSE activities are both timely and extremely important. By clearly identifying the risks of GSE activities to the taxpayer and assessing the impact of such activities on federal and federally-assisted borrowing, we will be in a much better position to anticipate any potential problems in the GSE area.

We look forward to working with the GSE's and other entities involved in conducting the studies, and to your continued interest in our efforts on the studies during the coming months.

This concludes my prepared statement. I will of course be happy to answer any questions you may have.

[The complete statement of Robert R. Glauber follows:]

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
October 31, 1989

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE SENATE BANKING COMMITTEE

Mr. Chairman and Members of the Committee:

I am happy to be here today to participate in this hearing on Government-sponsored enterprises and to discuss the GSE studies which Treasury will perform, as required under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

At the outset, let me say that we share your interest in GSEs, particularly with regard to the risk of taxpayer loss which they pose, their financial condition, and the adequacy of their current capital positions. As you may recall, Assistant Secretary Mullins in his April 18 testimony before the House Ways and Means Committee recommended that a Federal entity be asked to study the relationship between risks and GSE capital and to consider whether capital standards should be established for the GSEs. Thus, we are pleased that GAO will be conducting studies on capital requirements for GSEs, and we welcome the opportunity to perform Treasury studies to assess the financial safety and soundness of GSEs and the impact of their operations on Federal borrowing.

Over the years Treasury has been involved in a number of policy initiatives designed to control the growth and cost of Federal and federally-assisted credit. The Federal Government is the largest financial intermediary in the United States. At the end of FY 1988, the Government held $222 billion of outstanding direct loans (including $124 billion financed by the Federal Financing Bank) and had another $550 billion in outstanding guaranteed loans (including $451 billion of FHA and VA mortgages and $48 billion of guaranteed student loans). Government-sponsored enterprises, such as Fannie Mae and the Farm Credit Banks, had an additional $666 billion of outstanding loans at the end of the year (approximately $615 billion in the housing area and $51 billion in the agricultural sector). Thus, directly or indirectly, the Government had influenced the allocation of $1.4 trillion of outstanding credit to farmers, homeowners, small businesses, exporters, utilities, shipbuilders, and State, local and foreign governments.

While much public attention is focused on direct Treasury borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of off-budget guaranteed loans and borrowing by off-budget Government-sponsored enterprises. Yet, of the estimated $209 billion of net Federal and federally-assisted borrowing in FY 1990 (including the $4.5 billion of REFCORP bonds auctioned on October 25, but excluding prospective REFCORP borrowing), 49 percent is for financing the budget deficit, 15 percent for financing off-budget Federal loan guarantee programs, and 36 percent for financing off-budget GSEs. Taken together, it is clear that off-budget credit assistance from the Federal Government will be the largest component of total borrowing under Federal auspices in FY 1990.

FIRREA requires the Secretary of the Treasury to conduct two annual studies of the following eight GSEs:

- Federal National Mortgage Association (Fannie Mae), created in 1938 as a Government-owned corporation to provide a secondary market for federally guaranteed home mortgages. Fannie Mae became private in 1968, and since 1970 has become a major purchaser of conventional mortgages.
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- Farm Credit Banks, created in 1987 when the Federal Intermediate Credit Banks and the Federal Land Banks were merged. The Banks provide credit assistance for agricultural purposes.
- Banks for Cooperatives, created in 1933 to finance the operations of farmers' cooperatives. All but two of these banks were merged in 1988 into a single National Bank for Cooperatives.
- Federal Agricultural Mortgage Corporation (Farmer Mac), created in 1987 to shift the financing of farm loans from the bank loan market to the securities market.
- Student Loan Marketing Association (Sallie Mae), created in 1972 to provide liquidity to lenders involved in the guaranteed student loan program.
- College Construction Loan Insurance Association (Connie Lee), created in 1986 to guarantee and insure bonds and loans issued and made for the construction and renovation of college and university facilities.

The attached table provides aggregate data on the borrowing activities of the GSEs. Under FIRREA, the Secretary may also designate other GSEs to be included in the studies. However, given the limited resources which we have to devote to these studies, we may well limit them to the eight GSEs listed above.

With the exception of Connie Lee, the GSEs are privately owned entities, but are distinguished from fully private financial intermediaries by their close, favored relationship with the Federal Government. For example, GSEs generally have special tax exemptions; their obligations are eligible for open market purchase by the Federal Reserve; and, with the exception of securities issued or guaranteed by Farmer Mac, and securities guaranteed by Connie Lee, they are exempt from SEC registration. GSEs typically have authority to borrow limited amounts from the U.S. Treasury which helps to reinforce the market's perception of an implicit Federal guarantee of their outstanding debt, allowing them to borrow at interest rates lower than those available to fully private firms.

The value to the GSE of the Government's implicit guarantee depends largely on the operating policies adopted by the individual GSE. For a fully private firm, its borrowing costs are positively related to the market's perception of the risks that the firm undertakes and its activities. The implicit Government guarantee of agency debt, however, weakens the relationship between a GSE's cost of funds and the risks it assumes. The larger the gap between a GSE's actual cost of money and the cost it would have to pay if the Government were not seen as absorbing the risk of default, the greater the value of the implicit guarantee. Thus, GSEs have an incentive to take more risks, which could increase the taxpayer's exposure to potential loss.

Our two studies of GSE activities will, where possible, quantify the risks associated with each of the eight GSEs to be studied. In quantifying such risks, we will, as required under FIRREA, determine:

- the volume and type of securities outstanding which are issued or guaranteed by each GSE;
- the capitalization of each GSE; and
- the degree of risk involved in the operation of each GSE due to such factors as credit risk, interest rate risk, management and operation risk, and business risk.

In addition, we will report on the quality and timeliness of information currently available to the public and the Government concerning the extent and nature of GSE activities and the financial risks associated with such activities. We will also examine the growth and nature of GSE borrowing in the market and assess its impact on Federal and federally-assisted borrowing.

Although we are in the early, formative stages of the initial study, we have made considerable progress in establishing a broad set of issues for the study. As described above, FIRREA has clearly defined the parameters of the studies. Since the nature of a GSE's business and the operating policies of its management determine the risk exposure to the taxpayer, it is necessary to analyze each GSE separately. We have, therefore, decided to adopt a case study approach under which direct and indirect costs posed by the activities of each individual GSE will be studied in-depth. The case study approach will allow us to apply a common framework of analysis to each GSE, while recognizing that each GSE operates in a unique manner and environment.

The studies will require the cooperation of various Federal agencies and all the GSEs. We have already held several meetings with GAO staff which will be involved in conducting their study. While the focus of the GAO study is different from the focus of ours, we have agreed to coordinate our data collection efforts. Over the past three months, we have collected various data which will be needed for the studies. We have also met with several GSEs. The GSEs which we have contacted to date have been very cooperative. In addition, we have talked to private sector firms which may be of some help to us in analyzing the business and management risks posed by various GSE activities.

As you can see, our work on the studies has begun. Given our recent experience with the savings and loan crisis and the magnitude of GSE financial activities, we believe that the proposed studies of GSE activities are both timely and extremely important. By clearly identifying the risks of GSE activities to the taxpayer and assessing the impact of such activities on Federal and federally-assisted borrowing, we will be in a much better position to anticipate any potential problems in the GSE area.

We look forward to working with the GSEs and other entities involved in conducting the studies and to your continued interest in our efforts on the studies during the coming months.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

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OUTSTANDING DEBT OF GSEs
($ in billions, end of fiscal year 1988)

Federal National Mortgage Association	$273.2
Federal Home Loan Mortgage Corporation	241.3
Federal Home Loan Bank System	
Federal Home Loan Banks	126.7
The Financing Corporation	3.7
Farm Credit System	
FCS Financial Assistance Corporation	.4
Banks for Cooperatives	11.2
Farm Credit Banks	43.4
Student Loan Marketing Association	25.0
Total (gross)	$724.9
Less:	
Borrowing from other GSEs	$ .9
Borrowing from Federal sources	5.0
Investment in Federal securities	5.2
Borrowing for guaranteed loans held as direct loans	50.2
Borrowing with a Federal guarantee	.4
Subtotal for deduction to avoid double counting	$ 61.7
Total net borrowing	$663.2

Source: Table F-20, in "Special Analysis F", from Special Analyses, Budget of the United States Government, Fiscal Year 1990.

The CHAIRMAN. First of all, let me say that I think this is an excellent statement, and I appreciate the focus that it shows and the fact that the work is underway and that progress is being made. I am encouraged by that, and we want to work with you as we go down this track.

I must say to any of the other HBS types in the room, the case study approach that is being applied here sounds somewhat familiar, and hopefully will be a valuable way to do this.

You have come into government now in this position, you have been involved in important government service before; when you try to look at the much broader question of the outstanding debt levels generally, starting first with all the outstanding government debt levels—from the point of view of either all the deficits cumulative up to the present time to which we are adding a great deal as each week goes by, or the outstanding foreign debtor nation problem, or debt build-ups in off-budget agencies or GSE's do you have and idea how to put a framework around all of these major debt accumulations to try to get them into some kind of a broad composite of what in effect constitutes the debt position of the Government, direct and indirect?

Mr. GLAUBER. Well, I think it is indeed a difficult question, Mr. Chairman, as you suggest. I think one way to get some focus on it is to consider the impact on the markets; that is, the change in these outstanding debt positions each year. That is why I called emphasis in my statement to the fact that we will increase the amount of debt outstanding in these off-budget guaranteed and GSE programs as much as we will increase the debt outstanding in our on-budget programs. I think that is a very important point.

The CHAIRMAN. Yes.

Mr. GLAUBER. As you suggested in your comment a few minutes ago, these are growing very, very rapidly. Therefore, it makes a great deal of sense I think for us to try and get our arms around the meaning of this debt. It is a little more complicated than on-budget debt, because it is after all in many cases guarantee programs and not direct borrowing.

Guarantees are always something very difficult to understand, because people tend not to notice them until they explode and are required to be paid; an issue I know with which you are acutely familiar, since we spent most of nine months worrying about that.

The CHAIRMAN. Right.

Mr. GLAUBER. So it is not a trivial matter to get your arms around this, which is why Treasury encouraged that there be some study, and that this be done in a careful way. We are happy to be one of the participants in that study.

I just emphasize, obviously on the approach we have a certain bias—I do, my colleague Mr. Mullins does— coming from the Harvard Business School, to a case approach. Here I think it is necessary. It would be a grave error I think to lump all these GSE's into one basket. They are very different. It may well be that the risk positions and exposures of these institutions are very different one from another which is why we have decided to take the approach we have.

The CHAIRMAN. Well, let me try to ask another broad, economic policy dimension question. That is, if you take the amount of government borrowing, the part that is direct and now what you have stated is roughly an equal-sized amount that is indirect, we know at the same time that we have got a low and small savings pool in the country. We have got a savings problem, and we have had it for some time.

As the Government comes in it has certain advantages in going out and getting that money and preempting its access to the national savings pool, can you give us a rough sense as to the percentage of total savings that government borrowing, both direct and indirect, is taking out of that savings pool at the present time?

Mr. GLAUBER. I cannot give you a specific number on that, Mr. Chairman, but I think the thrust of what you are saying, if I understand it, is absolutely correct. These various programs are an element in the market place seeking loadable funds; and in so doing, they compete with other borrowers.

Clearly, as we have stated on a number of occasions, the best thing that we can do to reduce that competition, to ultimately lower the cost of capital, is to take steps to cut the amount of borrowing that the Federal Government has to do. Simply translated, to cut the federal deficit. And we are trying to do that.

One of the interesting issues that your question, and indeed your charge, raises is the matter of, to what extent is this competition for funds raising the cost to other borrowers? That is something that we are going to have to examine. There is a fixed amount of funds in some sense available, given the savings and investment decisions made by the private sector, given monetary policy, fiscal policy. And while it is possible to expand the funds, as we have done, by borrowing in the international markets, these various borrowing activities ultimately compete with each other.

In this particular situation, there is I think a further complicating factor. That is that these are somewhat segmented markets. The market for government debt, the market for so-called agency debt, are somewhat segmented, and they do not compete perfectly with each other. Nevertheless, clearly they abut against each other, and one of the things we are going to have to do in this study is to try to understand that interaction.

The CHAIRMAN. Now, to try to get some approximation here—and I appreciate that answer and the difficulty of this. You know, America has not thought of having had the need to try to assess these broad economic blocks of credit and debt and cost of capital considerations and so forth, because the world 10 or 15 years ago was sufficiently different that it did not compel us to do it. We should have been doing it anyway, but we did not understand the need, as a nation, to do it then. We clearly ought to understand the need now.

Would I be correct in thinking that the government credit needs, and the debt that government goes out to get each year, direct and indirect, would be as much as half of what we reckon the private savings pool in the United States to be?

Mr. GLAUBER. I think those numbers are in the ball park, yes.

The CHAIRMAN. Can we try to do this. I am sure I do not ask you to note this off the top of your head, but I am sure there is some savings pool data that we could take and make that relationship, to see if it is 50 percent, or 60 percent, or 40 percent.

My impression—and we are exchanging impressions, now—is that it is in the range of probably half or more of the private savings pool that we create each year as being taken down by government spending. Now, sometimes the government spending may be of such a priority and serve such a valuable economic purpose in the country that we do that on that justification. We understand it, and we decide that that is something we want to do as a matter of national strategy, and we do it.

I am concerned that we may have now reached sort of a critical mass aspect of this thing unwittingly. We may now be having so much government credit out there, direct and indirect, that is continuing to grow, that we are having an impact on private market needs that we are not aware, of as a sort of a by-product effect. And we have not really focused on that because that has not been the purpose of our analytical effort.

I think the cost of capital is now much higher in this country, for a variety of reasons: One, the low savings rate and savings pool that we have anyway; and two, because the Government preferential borrowing comes in and, because of the advantages, the direct guarantees and the implicit guarantees that attach to government debt, the Government gets its money, and the private sector can compete for what is left.

As I look at the comparative costs of capital right now for, say, manufacturing companies, or high-technology companies in the United States, versus those same companies in Japan, the differentials are enormous. I have seen figures that show that the cost of capital today in Japan can be as low as 2 percent. I mean, equity financing is very inexpensive, because the price-earnings ratios are sky- high; but even the debt levels are not all that high. There are all kinds of combinations of arrangements that go back and forth between manufacturing sectors and the banking sector in Japan, so it is not terribly surprising that they are buying Rockefeller Center, and Columbia Pictures—and the services of the former President, and a lot of other things, because they are in a very strong financial position.

I say all of that to get to the point that I would hope that, in addition to the GSE-by-GSE size-up that you are doing, we will attempt to try to do the macroeconomic analysis that tries to add all of the picture up at once. Namely, what are the total credit demands of the Government? To what extent are they impinging on this very small, anemic, national savings pool, and leaving us in a situation where it is getting harder and harder for us to try to correct our competitive problem internationally because we just do not have the capital available to finance a surge in private sector activity?

Now, there are a lot of other factors that impinge on this that you are looking at in terms of how the financial markets work, the leverage buy-out activities, and there are a lot of other things that I think slow us down and divert us from initiating a real surge in national productivity and output and a big jump in national income. But this area I think is one of the most important areas, and one of the ones that has been off the stage. It has not only not been center-stage, I do not even think it has been on the stage.

Now, through your efforts and the work of others, I think it is being put into focus. So I will just conclude that part by saying that I think it is as important that we understand the aggregate economic effect as it is that we understand the risk profile, GSE-by-GSE. So I would hope we could do both.

Mr. **Glauber**. Mr. Chairman, it was not exactly in the form of a question, but I would like just to associate myself with virtually everything you have said. There really is so much in what you have said with which I agree.

First of all, let me say that we will address the role of GSE's in competing for the pool of savings on this macro level. I think it is important, and I am very glad you raised it.

I just would add that it is a fact that these GSE's were established for public purposes by the Government, because it was believed at the time of their establishment that this was something proper to do, that it made sense to assist borrowers either directly or indirectly through the establishment of various secondary markets to accomplish the allocation of credit.

The **Chairman**. Right.

Mr. **Glauber**. So when it was done, and as it is renewed, it is assumed that these are useful purposes. They nevertheless, as you suggest, have a cost, and a cost which is heightened by the fact that we do have a savings rate in this country which is lower than it should be, and than we want it to be.

This, as you know, is a major concern of the Treasury, and I know it is a major concern of yours because we have discussed it from the time I arrived here. We need to increase that pool of savings, if we are going to accomplish all of these laudable purposes.

The **Chairman**. Well, I will just trespass on your time and everyone else's for one more minute, on this subject, because I think it is so important.

I think each one of these activities may very well have a necessary and laudable public purpose, and to the extent we can afford to do that activity or more of that activity we would like to do it. But I think what can sometimes happen is that we do not think of the cumulative effect or the aggregate effect, where you have got a lot of things running at once, and they are all growing; and that is then measured against an anemic savings pool.

I would just make a rough analogy to what I think happened during the Vietnam war, if I may. I was here in the Congress at that time, and spent a lot of time working on it. I think, in this rough analogy, as we began to invest American troops and resources the nature of the strategic aspect of that commitment changed very dramatically. When it was at one scale, it had one kind of implication, and we increased it in stages. And without realizing it, at some point we graduated into a strategic commitment that had an entirely different meaning, and one that we did not really think about in that way, because we had gradually taken steps.

We woke up one day and found that we had 500,000 troops over there and we were spending several multiples of tens of billions of dollars a year, and everybody sort of said, "Well, this was not really what we had in mind when we started out cver here."

And, to not bog down on that analogy, I think our overriding economic quandary of how we finance a surge in national economic performance and output tracks back to a whole series of pressure points and difficulties, of which this is a major one.

Getting it up on the table and into focus, so we can understand what our choices and trade-offs are as a country, is part of how I think we can make some intelligent decisions in terms of our competitive future. We must turn ourselves into a situation where, instead of adding international debt off the trade deficit of a billion dollars every three days, which we are now doing, we can figure out how to get to a point where we at least break even, and maybe start to work off some of this international debt.

Mr. GLAUBER. I would quite agree with you that incrementalism can be a very dangerous way of doing business. You ought not to build a factory one brick at a time; you ought to decide what kind of factory you want. I think we are often in danger of doing that.

Various purposes which by themselves seem laudable and worthy of commitment of funds, when measured against others, may not be.

The CHAIRMAN. I am going to give you four or five questions for the record. I want to just ask one or two more here.

Do you think presently that the Treasury Department and other Cabinet departments have adequate legal authority in present law to regulate and to supervise the GSE's?

Mr. GLAUBER. I think that is a very good question.

Our approach to oversight over the years has been something which I must admit, being a newcomer here, I do not fully understand. It appears that what we have done—and properly so, I would imagine—is to give the oversight function primarily to the front-line agency that has responsibility. In the case of Fannie Mae and Freddie Mac, HUD, and so forth.

What Treasury has done is to use its authority—which on the books is authority to control the amount of borrowing, the form of borrowing, the interest rates in most of these GSE's—we have used it mainly as a traffic cop, to make certain that they do not step over each other or over Treasury borrowing. And in times of emergency or crisis in the financial markets, we would restrain them. But it has been a second-line authority.

I am not certain that in fact we are prohibited—and indeed, I have been told by our attorneys that we have powers that on the surface go beyond that. But there is some ambiguity between our role and the front-line, oversight authority.

That is something I think that we ought to try to understand better as we proceed through this study.

The CHAIRMAN. Now, Treasury has got the authority, as I understand it, to disapprove the issuance of interest-bearing securities by GSE's. Has the Treasury ever done so, because of concerns about financial risk?

Mr. GLAUBER. As I understand it, we have never specifically disallowed one because of reasons of financial risk. We have used our traffic cop function to try and have it moved in timing.

The CHAIRMAN. I see.

Mr. GLAUBER. But we have never, as I understand it, by reason of financial risk. I think, were we to do so, it would be viewed as being out of the ordinary, certainly out of the ordinary of our past practice.

The CHAIRMAN. You know, I am just thinking—this is not a proposal; it is just a thought that comes to my mind in the course of this discussion—but it seems to me that we may need to have in the Government a sort of a free-standing capability separate from any of these GSE's that really looks at the requirements and the needs of all of them at once, so that we are not in a situation where it is just a pass-through operation, but where we really have an opportunity to measure our financial capacity.

I mean, that is really the issue here: What is our financial capacity? And we can set things in motion that can run beyond our financial capacity, quite apart from extraneous risk factors. I am concerned that we are now to such a volume of outstanding debt that we could unwittingly be in that zone, or be about to go into that zone, without really having any structured way to look at that question and decide it objectively in the national interest.

Mr. GLAUBER. Well, of course there is in a sense two, maybe more, issues running around here at the same time. One of them is really the risk exposure of these various GSE's and whether it would be prudent at a particular time, given their risk exposure, to restrain them, and, very frankly, I at this point just can't give you any guidance on that.

The CHAIRMAN. I am not really referencing that directly.

Mr. GLAUBER. I know you are not asking of course.

The CHAIRMAN. But it is coming.

Mr. GLAUBER. Presumably once we go through this analysis I will be better able to come before you and talk about that.

The other issue is this question of aggregate demands on funds in the market, which I take is implicit in what you are raising.

The CHAIRMAN. Yes.

Mr. GLAUBER. What we do have is a system where Congress controls the amount that the government borrows directly, I mean, for its own purposes, but these GSE's are under a very different form of control, or lack of control.

The CHAIRMAN. Yes, I think that is more the issue. It sounds to me like we have got control at one level, but we don't have control really at the other level. We have sort of a micro control of sorts, but we don't have any kind of a macro control. That may be where the real risk could be developing: in the aggregate of the activities of all of these entities taken together.

Mr. GLAUBER. Well, that of course returns to the first theme you emphasized, and again I think it is one that you are quite correct in emphasizing. It is something about which I think we have to get a better feel for, and I will be happy to report back to you about it.

The CHAIRMAN. I would hope that one of the things that would come out of the study would be—and I am sure you will think along these lines—what kind of mechanisms may be needed that don't presently exist. We need structural mechanisms, to allow national economic strategic assessment to go on. That, again, is not to prejudice the purpose of any of the activities, but simply to look at our capacity and the degree to which we may be going out beyond the outer bounds of what we should wisely try to do just from an overall national financial capacity point of view.

Mr. GLAUBER. I accept what you are saying. Again, I, with you, would emphasize, I think, the need for us to expand our capacity, which is why we all, both of us, I think care greatly about trying to increase the savings rate. But I agree also that we have to try and assess the demands we are putting on the available funds measured against the amount of funds that are available.

The CHAIRMAN. Let me ask just one other thing. I understand that two and a half months ago Secretary Brady organized an Administration-wide working group to, among other things—and I quote—"review activities of GSE's and establish appropriate federal government policies to control the risks of such programs." And I want to say that I commend the Treasury for that initiative, and I know you have been important to it.

Can you tell us anything about the progress and direction of that working group?

Mr. GLAUBER. That I would say is really just getting off the ground. It is an EPC working group, under the Economic Policy Council. It has met at the staff level on a couple of occasions. It is an interagency group. I know the Secretary is meeting with the entire group in a couple of weeks to give them further guidance, and I will be happy to keep you posted on the progress of that group.

The CHAIRMAN. I would appreciate that.

We have some other questions that we will submit to you from the record and from some of the other Senators, but I appreciate the directness of your testimony and your answers today.

Mr. GLAUBER. Again, let me extend my apologies for my tardiness.

The CHAIRMAN. Fully understood. Thank you very much. Let me excuse you as a witness now and call our remaining two witnesses for the morning—Mr. Thomas Stanton, who is the Counsel for Olwine, Connelly, Chase, O'Donnell & Weyher, here in Washington, D.C., and Mr. Andrew Carron, who is the Director of the Fixed Income Research area of the First Boston Corporation, based in New York.

And let me welcome both of you. We are pleased to have you with us today. You have had the opportunity to hear the testimony that has already been given, and so I would hope that in the course of your summary comments that you would cross-relate any of the observations that you want to share with us today with other things that have been said. So feel free to sort of work off other comments and information that has been presented today that you might agree with, disagree with, or what have you.

But we are pleased to have you both, and, Mr. Stanton, let us hear from you first.

STATEMENT OF THOMAS H. STANTON, COUNSEL, OLWINE, CHASE, O'DONNELL & WEYHER, WASHINGTON, DC

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. Let me say one other thing. We will make your full statements a part of the record and again ask you to summarize the key points in your testimony.

Thank you.

Mr. STANTON. Thank you for the invitation to testify today.

I am a Washington, D.C. attorney and am speaking today only on my own behalf and not for my law firm or any client.

My testimony as submitted to the committee focuses on the need to assure safety and soundness of government-sponsored enterprises through effective regulation and capital standards. Mr. Chairman, the statement makes many of the points that you raised earlier in your opening statement about the analog to thrift institutions, the concern about a federal government guarantee and the federal government's essential need to police what private parties are doing with that guarantee.

As you pointed out, Mr. Chairman, the volume of outstanding enterprise securities today is very close to the total volume of federally insured deposits of thrift institutions.

Some reference has been made to the need for federal oversight. I would only like to point out that regulators of government-sponsored enterprises have not tended to be of the same quality we have come to expect of bank regulators, for example.

The Department of Housing and Urban Development lacks the resources to oversee the safety and soundness of Fannie Mae, with $290 billion in assets and mortgage-backed securities, and of Freddie Mac, with $260 billion of assets and mortgage-backed securities.

The Washington Post recently reported that HUD lacks even a single official with full-time responsibility for regulating operations of the two institutions. Indeed, a HUD spokesman pointed out that the Department uses attorneys from their Office of General Counsel whenever "something comes up." The spokesman told the Washington Post, "It is not as if we have to have someone watching them every day."

Mr. Chairman, we have $600 billion worth of eggs in those two baskets, and it would be much more comforting if someone were watching them every day.

Moreover, as Wall Street analysts have pointed out, the capital requirements for Fannie Mae and Freddie Mac are illusory because they count as capital their subordinated debt that is also implicitly guaranteed by the government. Unlike the new risk-based capital requirements for banks, Fannie Mae and Freddie Mac do not need to count their hundreds of billions of dollars of contingent liability for mortgage-backed securities when computing their statutory capital levels.

Fannie Mae, for example, at year-end 1988 had only $2.3 billion of shareholder capital to support $290 billion of assets and guaranteed securities. Freddie Mac had only $1.6 billion of shareholder equity to support $260 billion of assets and guarantees. This works out to a capitalization of 0.8 percent and 0.6 percent, respectively.

We may recall that the Federal Home Loan Bank Board at one time was working on a policy of early closure of thrift institutions that would have less than 1.5 percent capital, and of course this is substantially below the capital requirements established for commercial banks by the bank regulators.

I would like to focus for a moment on the changes FIRREA caused for Government-sponsored enterprises.

Our financial markets today are highly integrated. FIRREA sought to shore up the safety and soundness of thrift institutions, but in the process also involved Government-sponsored enterprises. The problem is that we have to be careful that in addressing safety and soundness of the primary market we didn't inadvertently shift moral hazard and substantial financial risk into the secondary market, particularly the secondary market, including Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

It is too early to predict all of the consequences of FIRREA for government-sponsored enterprises, but even now some implications for safety and soundness are apparent, and I would like to point out four items of special note.

First, FIRREA imposes significant capital requirements on thrift institutions. This will give them an incentive and is already giving them an incentive to sell literally tens of billions of dollars of mortgages to Fannie Mae and Freddie Mac and thereby accelerate the growth of those two enterprises. By contrast, the downsizing of thrifts will reduce the funding base and the customer base of the Federal Home Loan Bank System.

Secondly, FIRREA permits Fannie Mae and Freddie Mac to make loans on the security of mortgages. This means that for the first time they can compete directly with the Federal Home Loan Bank System in its core line of business, which is making advances to thrift institutions. This new competition could have significant implications for the future safety and soundness of the Home Loan Banks, which until now have been very well capitalized and extremely profitable.

Third, FIRREA provides Freddie Mac a shareholder controlled board of directors. This change means that the corporation's past record of financial prudence could be affected by new pressures to maximize short-term shareholder returns.

Finally, FIRREA makes the U.S. Department of Housing and Urban Development the regulator of Freddie Mac despite that Department's poor record of oversight of Fannie Mae's safety and soundness.

In conclusion, fortunately, it appears that most enterprises have been well run despite the moral hazard created by the implicit federal guarantee and weak federal oversight. The problem is that just as was true of thrift institutions the legal confinement of enterprises to making specialized kinds of loans—home mortgages, student loans, agricultural loans, advances to thrift institutions—means the profitability today cannot assure financial soundness tomorrow. Because of the lack of loan diversity one systematic problem with credit risk or interest risk or inadequate management systems can suddenly translate into substantial financial damage. It is time now before another enterprise gets into trouble to institute effective capital standards and regulation of safety and soundness.

Thank you.

[The complete statement of Thomas H. Stanton follows.]

Statement of

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Presented to

The Committee on Banking, Housing, and Urban Affairs
United States Senate

Hearings on

Oversight of Government Sponsored Enterprises

October 31, 1989

Summary Statement of

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Presented to the Committee on Banking, Housing, and Urban Affairs, United States Senate

Oversight of Government Sponsored Enterprises

October 31, 1989

I. It is time to apply to government sponsored enterprises the financial safety and soundness lessons from FSLIC's insolvency. Otherwise the government may simply shift its multibillion dollar financial exposure to another set of institutions with similar vulnerabilities.

   A. Government sponsored enterprises have many characteristics in common with thrift institutions.

   B. Federal regulation of safety and soundness and effective capital standards must compensate for the market discipline enterprises lose because of their federal credit support.

   C. Most government sponsored enterprises are not well regulated to assure financial safety and soundness.

II. Safety and soundness of government sponsored enterprises must be addressed as a part of our integrated financial system.

   A. Financial institutions can shift risk easily to the place where the government is least equipped to deal with it.

   B. FIRREA will have significant consequences for government sponsored enterprises.

III. Conclusion

Fortunately, most enterprises have been well run despite the "moral hazard" created by the implicit federal guarantee and weak federal oversight. The problem is that, just as was true of thrifts, the legal confinement of enterprises to making specialized kinds of loans -- home mortgages or student loans or advances to thrift institutions, for example -- means that profitability today cannot assure financial soundness tomorrow. Because of the lack of loan diversity, one systematic problem with excess credit risk or interest risk or inadequate management systems can suddenly translate into substantial financial damage. It is time now, before another enterprise gets into trouble, to institute effective capital standards and regulation of safety and soundness.

Mr. Chairman, Members of the Senate Banking Committee:

Thank you for the invitation to testify today at these oversight hearings on government sponsored enterprises. My name is Thomas H. Stanton and I am a Washington, D.C. attorney whose practice includes a variety of matters relating to government sponsored enterprises and other financial institutions. I am speaking today on my own behalf and not for my law firm or any client.

The Senate Banking Committee is to be commended for holding these oversight hearings. The three largest enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLBS) conduct their operations under legislation enacted by the congressional banking committees. Oversight is especially important now because the decline of the thrift industry and the recently enacted Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) will have significant consequences for the structure and operations of these enterprises.

In my testimony today, I would like to focus on the need to assure the safety and soundness of government sponsored enterprises through effective federal regulation and capital standards. As was the case with FSLIC and federal deposit insurance, the federal government implicitly guarantees that enterprises will not default on their obligations. That means the government faces substantial financial exposure if it neglects the financial safety and soundness of government sponsored enterprises.

Today the government implicitly guarantees over $700 billion in enterprise obligations and securities -- almost as large a federal contingent liability as from FSLIC-insured deposits. Yet, government sponsored enterprises tend to be even less regulated financially and are subject to less strict capital requirements (if any) than are thrift institutions. Unless this problem is addressed, we risk repeating today's thrift-type problems with a different set of financial institutions.

Second, our financial markets today are highly integrated. By shoring up safety and soundness of thrift institutions, and in other provisions directly affecting enterprises, FIRREA will affect the safety and soundness of government sponsored enterprises in a variety of ways. This committee must assure that, in imposing effective federal supervision and capital standards on thrift institutions, we have not merely shifted moral hazard and other financial risk from the primary market to the secondary market consisting of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

I. It is time to apply to government sponsored enterprises the financial safety and soundness lessons from FSLIC's insolvency. Otherwise the government may simply shift its multibillion dollar financial exposure to another set of institutions with similar vulnerabilities.

A. Government sponsored enterprises have many characteristics in common with thrift institutions.

Enterprises are perhaps best understood in comparison to thrift institutions. Both kinds of financial institution are federal instrumentalities that use federal backing to lower their cost of funds. Enterprises differ from thrifts in size and in the particular form of the federal government's implicit guarantee. They resemble thrifts in their confinement by law to specialized lending activities.

Fannie Mae and Freddie Mac purchase home mortgages in the secondary market, Sallie Mae funds student loans, the Farm Credit System and Farmer Mac deal in agricultural loans, the Federal Home Loan Banks lend to thrift institutions, and the Financing Corporation (FICO) and Resolution Funding Corporation (REFCORP) provide funds to help the government close insolvent thrifts.

These enterprises benefit from federal credit support that permits them to issue virtually unlimited volumes of debt obligations and guaranteed securities in the federal agency credit market. As discussed in Appendix A to this testimony, enterprise obligations and securities benefit from an implicit federal guarantee that can reduce enterprise borrowing costs significantly.[1]

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[1] For discussion of the implicit federal guarantee and goverment sponsored enterprises, see e.g., Michael Moran, "The Federal Sponsored Credit Agencies: An Overview," Federal Reserve Bulletin, Vol. 71, No. 6, pp. 373-378 (June 1985); and Thomas H. Stanton, "Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy," pp. 1-8, 17-18 (1988).

Partly because of this federal credit support, and sometimes because of other benefits such as freedom from the significant capital requirements imposed on competitors such as banks and thrifts, enterprises tend to expand greatly within their permitted markets. They can become huge institutions. At year-end 1988, for example, Fannie Mae had $112 billion of assets plus $178 billion in guaranteed mortgage-backed securities, and Freddie Mac had $34 billion of assets plus $226 billion in guaranteed securities. Sallie Mae, one of the smaller enterprises, grew by 25 percent last year and at year-end 1988 held $28.6 billion of assets.

The private managers of these enterprises determine how much they will grow within their available market segments; as they grow, the federal government's contingent liability expands accordingly. This is an open-ended extension of federal credit support comparable to the government's exposure from federal deposit insurance. The government's backing of enterprise obligations is, if anything, even greater than was its liability for thrift institutions. Thrift institutions had only a part of their obligations, FSLIC-insured deposits up to $100,000 per account, backed by the federal government in contrast to government backing of all enterprise obligations.

B. Federal regulation of safety and soundness must compensate for the market discipline enterprises lose because of their federal credit support.

The financial failure of FSLIC dramatically documents the need for effective regulation, including capital requirements, to protect the safety and soundness of institutions whose market discipline is undercut by operation of a federal guarantee.

There is a substantial literature on the need for effective regulation to protect safety and soundness of such institutions.[2] Because of the government guarantee, investors may not care much about the creditworthiness of an enterprise or the loans it purchases or guarantees. Instead, investors will largely look to the implicit government backing for their assurance.

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[2] Much of this literature contains lessons from federal deposit insurance. See e.g., Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," pp. 17-27, Business Review, January/February 1982, Federal Reserve Bank of Philadelphia; Fischer Black, Merton H. Miller and Richard A. Posner, "An Approach to the Regulation of Bank Holding (footnote continued)

For a normal corporation, without such federal backing, investor concern about creditworthiness provides an important market place constraint on risk taking. First, shareholders have a long term interest in protecting and enhancing their capital investment in the company. For enterprises such as Fannie Mae and Freddie Mac however, their charter legislation significantly reduces the financial stake of investors by permitting them to invest very little shareholder capital compared to the government's huge stake in hundreds of billions of dollars of implicitly guaranteed obligations and mortgage-backed securities.[3]

Indeed, as one Wall Street analyst has pointed out, the capital requirements for Fannie Mae and Freddie Mac are illusory because they count as capital their subordinated debt that is also implicitly guaranteed by the federal government.[4] Moreover, unlike the new risk-based

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Companies," Journal of Business, Vol. 51, No. 3, (1978), pp. 379-412; Sherman J. Maisel, Ed., Risk and Capital Adequacy in Commercial Banks, especially Chapter 6 (1981); see also Kevin E. Villani, "The Federal Forecast," Secondary Mortgage Markets, Spring 1985, pp. 26-33, Federal Home Loan Mortgage Corporation; and Edward J. Kane, "Comments," pp. 181-189, The Federal National Mortgage Association in a Changing Economic Environment (Symposium), U.S. General Accounting Office, July 17, 1985.

[3] Fannie Mae, for example, at year-end 1988 had only $2.3 billion of shareholder capital to support $290 billion of assets and guaranteed securities; Freddie Mac had only $1.6 billion of shareholder equity to support $260 billion of assets and guarantees. This is substantially below the capital requirements established for commercial banks by the FDIC, Comptroller of the Currency, and the Federal Reserve Board.

[4]

> "Contrary to appearances, however, Fannie Mae has little reason to view capital requirements as a prospective constraint on its future operations. What makes HUD's requirement a red herring is that Fanhie Mae is allowed by statute to include subordinated debt in its computation of regulatory capital. While the company's debt-to-equity ratio

(footnote-continued)

capital requirements for banks, Fannie Mae and Freddie Mac do not need to count their hundreds of billions of dollars of contingent liability for mortgage-backed securities when computing their statutory capital levels.

While enterprise management may in fact develop prudent business policies, there is considerable incentive to seek extra returns for taking excessive risks. Economists call this "moral hazard." Heads, the corporation and its shareholders win; tails, the U.S. taxpayer pays for the big mistakes.

Market discipline normally also comes from investors other than shareholders. Without the federal government's backing, a corporation is subject to considerable restraint when it issues debt obligations or guarantees securities. Before investors rely upon an obligation or guarantee, they require assurances about the company's financial backing. Investors check not only the balance sheets of the corporation providing the obligation or guarantee but also the credit quality of the assets standing behind the obligation or guarantee.

However, investors in enterprise securities are unlikely to provide such market discipline because each enterprise relies on the federal government's backing to sell its obligations and guarantees. Investors in enterprise securities will be spared the need for much examination of the creditworthiness of the institution, its assets, or asset pools. Instead, they can be expected to rely largely upon the implicit guarantee upon which the enterprise's obligations and guarantees will be based.

> on a GAAP basis is 45:1, on a regulatory basis, including subordinated debt, it is currently 18:1. Thus, Fannie Mae can always improve its regulatory capital ratio further by raising additional subordinated debt. Fannie Mae pays only 10 to 15 basis points more for subordinated debt than for other debt instruments; the public markets perceive Fannie Mae's subordinated debt as implicitly backed by the federal government, which would almost certainly prove correct if Fannie Mae ran into trouble."

First Boston Corporation, "A Flurry or Recent Articles Takes Swipes at Fannie Mae; No Reason for Investor Concern; Maintain BUY Option," April 14, 1989, p. 2.

Again, this means that an enterprise can take much greater risks than could a private company in this line of business without federal support. An enterprise has an extensive market for its debt obligations and guarantees even if, for example, it is undercapitalized and does not adequately police the credit quality of loans it makes or securities it guarantees.

Risk-taking can take a variety of forms. In the late 1970's, for example, Fannie Mae made the mistake of many thrift institutions and funded a huge portfolio of long-term mortgages with short-term borrowings. When interest rates rose, Fannie Mae's funding mismatch resulted in a market value negative net worth of $10.8 billion by 1981. Only energetic new management strategies and declining interest rates saved the enterprise from calamity.

The Farm Credit System (FCS) was not as lucky. Again, abetted by the implicit federal backing, FCS institutions undertook substantial interest rate risk (this time funding short-term lending with longer-term borrowings) and credit risk, and failed to price loans properly. For example, by 1981, FCS institutions were offering farm borrowers loans at rates of interest five percentage points below competing rural lenders. When the agricultural economy went into decline, the FCS announced it could not meet its obligations.

Congress has now established a $4 billion off-budget Financial Assistance Corporation, to pay for the restructuring or closing of farm credit institutions. This funding device was a model, with some technical variations, for the Resolution Funding Corporation that will be used to pay for failed thrift institutions. The federal backing of enterprise obligations may be implicit, but it is very real. As in the case of the Farm Credit System, taxpayers have literally billions of dollars at stake if an enterprise fails to meets its obligations.

The lesson of the farm credit insolvency and the FSLIC calamity is that the federal government must deal with this problem by creating a capable independent regulator to set meaningful capital standards and oversee safety and soundness of institutions whose obligations it supports. While regulation is not a complete substitute for market discipline as a means of protecting the safety and soundness of a government sponsored enterprise, it is essential to help protect the institution's long term viability.

C. Most government sponsored enterprises are not well regulated to assure financial safety and soundness.

Unfortunately, despite this clear lesson, most government sponsored enterprises are not subject to capable regulation of their safety and soundness. The Department of Housing and Urban Development (HUD) is supposed to regulate Fannie Mae and Freddie Mac. The Farm Credit Administration (FCA) regulates the farm credit institutions and Farmer Mac. Before 1985 the FCA lacked independence from the regulated farm credit institutions; the government only turned the FCA into a serious financial regulator after the Farm Credit System lost billions of dollars. Sallie Mae has no financial regulator at all.

The first problem is that a regulator such as HUD lacks the resources to oversee safety and soundness of a Fannie Mae with $290 billion in assets and mortgage-backed securities and a Freddie Mac with $260 billion of assets and mortgage-backed securities. The Washington Post recently reported that HUD lacks even a single official with full-time responsibility for regulating operations of the two institutions.[5] This contrasts with the policy of a serious financial regulator, the Office of the Comptroller of the Currency, that has a policy of maintaining a continuous on-site examination staff at the largest institutions it supervises.[6]

The second problem is that regulators often lack a clear focus on safety and soundness. Often their attention is absorbed by issues relevant to their overall missions that can be quite different from concerns about enterprise soundness. For example, HUD tends to concentrate on national housing policies rather than on narrower matters such as Fannie Mae's financial well-being. Given HUD's track record overseeing Fannie Mae, the U.S. General Accounting Office has called upon Congress to clarify that HUD has a regulatory responsibility for overseeing the financial soundness of Fannie Mae's activities.[7]

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[5] Jerry Knight, "Bailout of S&Ls Spurs Probes of Other Programs: Hill Examines Taxpayer Liability in Huge U.S.-Backed Enterprises," Washington Post, pp. H1, H4, October 15, 1989. The department uses attorneys from the HUD General Counsel's Office "when something comes up" with Fannie Mae or Freddie Mac, a HUD spokesman told the Post. "It's not as if we have to have someone watching them every day."

[6] For a recent statement of supervisory policies by the bank regulators, see, e.g., Federal Deposit Insurance Corporation Staff Study, Deposit Insurance for the Nineties: Meeting the Challenge, Chapter 5 (Draft, January 4, 1989).

II. Safety and soundness of government sponsored enterprises must be addressed as a part of our integrated financial system.

A. Financial institutions can shift risk easily to the place where the government is least equipped to deal with it.

Today's financial markets are highly integrated. Financial institutions can shift risks among themselves to take advantage of pricing opportunities and also to benefit from the least onerous federal requirements. Consider, for example, a commercial bank with a portfolio of residential mortgages. Under the risk-based capital requirements now being implemented, commercial banks will have to set aside risk-based capital amounting to four percent of the value of the good quality residential mortgages they hold. (These mortgages are in the 50 percent risk-weight category).

By contrast, if the commercial bank swaps its mortgages for Fannie Mae or Freddie Mac mortgage-backed securities, it will be required to set aside risk-based capital amounting to only 1.6 percent of its holdings of those securities. (Fannie Mae and Freddie Mac mortgage-backed securities are given a 20 percent risk-weight). Except for the enterprise guarantee, the mortgages and mortgage-backed securities would have the same financial characteristics such as amount, yield, and maturity.

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[7] U.S. General Accounting Office, The Federal National Mortgage Association in a Changing Environment, p. 117 (1985). The Federal Home Loan Bank Board, until recently the regulator for Freddie Mac and the FHLBS, suffered from conflicting responsibilities that interferred at times with its responsibility for safety and soundness of the two enterprises.

Similarly, a bank will be able to sell agricultural mortgages into a pool and purchase corresponding Farmer Mac mortgage-backed securities. This would reduce risk-based capital requirements from 8 percent of the assets (agricultural mortgages have a 100 percent risk-weight) to 1.6 percent (Farmer Mac mortgage-backed securities will have a 20 percent risk-weight).

The federal bank regulators have not yet agreed on minimum capital requirements, in addition to the risk-based capital requirements, that will affect the amount and extent of this advantage. Nevertheless, enterprise mortgage-backed securities appear to offer a convenient way for some banks (and thrifts) to reduce the capital requirements on their asset portfolios.

Because Fannie Mae, Freddie Mac, and Farmer Mac are not subject to capital requirements on the volume of the mortgage-backed securities they guarantee, they provide a means for financial institutions to reduce the overall level of private capital required by the federal government even though the government may retain the same overall level of exposure to credit risk. The locus of that credit risk has merely shifted from a commercial bank or thrift with federally insured deposits to a government sponsored enterprise with an implicit federal guarantee of its mortgage-backed securities.

As the international financial regulators determined in designing the Basle Accords on risk-based capital requirements, capital standards must be coordinated across financial institutions to avoid creating such adverse consequences. Similarly, regulation of safety and soundness needs to be comparable across financial institutions.

B. FIRREA will have significant consequences for government sponsored enterprises.

It is too early to predict all of the consequences of FIRREA for government sponsored enterprises. Even now, however, some implications for safety and soundness are becoming apparent.

- FIRREA imposes significant capital requirements on thrift institutions. This will give them an incentive to sell billions of dollars of mortgages to Fannie Mae and Freddie Mac, and thereby accelerate the growth of the twc enterprises. By contrast, the down-sizing of thrifts will reduce the funding base and customer base of the Federal Home Loan Bank System;

- FIRREA permits Fannie Mae and Freddie Mac to make loans on the security of mortgages. This means that they can compete directly with the FHLBS in making advances to thrift institutions. Such new competition could have consequences for the future of the FHLBS;
- FIRREA provides Freddie Mac a shareholder-controlled board of directors. This change means that the corporation's past record of financial prudence could be affected by new pressures to maximize short-term shareholder returns; and
- FIRREA makes the U.S. Department of Housing and Urban Development the regulator of Freddie Mac, despite that department's poor record of oversight of Fannie Mae's safety and soundness.

It is time to address systematically the issues of moral hazard and financial risk for government sponsored enterprises so that we do not repeat today's thrift-type problems with yet other financial institutions in the future. It would be unfortunate if the government acted to assure safety and soundness of institutions in the primary market and shifted risks to the secondary market instead.

III. Conclusion

Fortunately, most enterprises have been well run despite the "moral hazard" created by the implicit federal guarantee and weak federal oversight. The problem is that, just as was true of thrifts, the legal confinement of enterprises to making specialized kinds of loans -- home mortgages or student loans or advances to thrift institutions, for example -- means that profitability today cannot assure financial soundness tomorrow. Because of the lack of loan diversity, one systematic problem with excess credit risk or interest risk or inadequate management systems can suddenly translate into substantial financial damage. It is time now, before another enterprise gets into trouble, to institute effective capital standards and regulation of safety and soundness.

Thank you.

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APPENDIX A

The Government's Implicit Guarantee of Enterprise Obligations and Mortgage-Backed Securities

Thrifts use federal deposit insurance to obtain their federal credit support, at least for depositor accounts up to $100,000. Enterprises use a different device that gives them even greater backing: their obligations have the attributes of federal Treasury obligations and their guaranteed securities have the attributes of government-backed securities such as are guaranteed by the Government National Mortgage Association, a part of the U.S. Department of Housing and Urban Development. Even though enterprises are owned by private shareholders and controlled by private managers, the obligations have governmental attributes and trade in the federal credit agency market at favorable rates of interest close to those of the U.S. government.

Like U.S. Treasury obligations, enterprise obligations, with some variations, have the following characteristics:

- They may be issued only upon approval of the Secretary of the Treasury, who often also approves terms such as interest rate and maturities;

- They are exempt from regulation by the SEC except to the extent the U.S. government securities are regulated;

- They are lawful investments for federally supervised institutions, including banks, thrift institutions, and credit unions and have favorable government-type status in the portfolios of these institutions. (For example, shorter-term enterprise obligations may be used to meet liquidity requirements of thrift institutions, and national banks may invest and deal in enterprise obligations without limit);

- They are lawful investments for federal fiduciary, trust and public funds;

- They are issuable and payable through the facilities of the Federal Reserve Banks;
- They are eligible collateral for Federal Reserve advances and discounts and are eligible to be bought and sold in Federal Reserve open market operations; and
- For most enterprises, they are exempt from state and local taxation.

The one big difference between enterprise securities and U.S. Treasury obligations is that enterprises are privately owned and are not part of the federal government. The enterprises have additional characteristics that strengthen the perception of governmental backing:

- They are federally chartered instrumentalities of the United States;
- They have a direct or indirect line of credit with the U.S. Treasury; and
- They are controlled by boards that include some governmentally-appointed directors.

Taken together, these attributes amount to an implicit federal guarantee that enterprises will not be allowed to default on their obligations. The federal government makes a strong statement to investors by conferring on enterprise securities the same preferred investment status as U.S. Treasury obligations. The exemption from the usual SEC registration laws removes investor protections considered necessary for all but the most secure (i.e., federally-backed securities). Similarly, the exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally-backed securities. Investors perceive that the government would not permit these exemptions from basic investor protection unless enterprise securities were extremely safe.

This means that investors look primarily to the implicit federal backing as a guarantee of an enterprise's creditworthiness, rather than looking towards its balance sheet. Thus, while borrowing costs did rise somewhat for the Farm Credit System, even after that enterprise recorded $4.6 billion of losses in 1985 and 1986, Farm Credit System securities remained eligible investments for AAA-rated debt.

Over time, the market can become even more confident about the government's likelihood of backing obligations of government sponsored enterprises. As the value of outstanding enterprise obligations increases, so does the inability of the federal government to intimate that it would not stand behind this debt.

When the Continental Illinois Bank failed, for example, the federal government stood not only behind FDIC-insured deposits, but also protected uninsured bank creditors, and even creditors of parent holding company. The Comptroller of the Currency told Congress of fears of a domestic and possible an international financial crisis if all Continental creditors were not protected. The Comptroller of the Currency concluded that because of their size alone, the federal government cannot permit the failure of any of the nation's largest money center banks, many of which are significantly smaller than government sponsored enterprises. Continental Illinois was the nation's sixth largest bank. It had assets of approximately $40 billion, and was significantly smaller than were Fannie Mae, the Federal Home Loan Bank System, or the Farm Credit System.

Because the federal backing for enterprise obligations is implicit rather than express, the market tends to require a slightly higher return on enterprise obligations, than from direct Treasury debt. Even though the federal backing of enterprise securities may be implicit, it is very real. As in the case of the Farm Credit System, taxpayers have literally billions of dollars at stake if an enterprise fails to meet its obligations.

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Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability

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Political priorities of the moment too often move the federal government to establish entities whose structure and operations depart from important principles of public law and private management. Similar programs and institutions are dispersed widely across the government and even beyond the margins of government. They are accountable, if at all, to a variety of federal agencies and congressional committees. As a consequence, the federal government generally, and the President and central managerial agencies in particular, have seen an erosion of their capacity to supervise these critical activities.[1]

The line between what is "public" and what is "private" has become indistinct.[2] Some scholars and practitioners approve of this blurring of public and private sectors as innovative and inevitable,[3] while others fear that sector blurring violates sound constitutional principles and ultimately threatens the ability of elected and appointed officials to maintain an orderly and responsible democratic system of government.[4]

Harold Seidman correctly concludes that the United States has entered an era of "quasi government" where functions of a public character are increasingly assigned to entities whose legal status has been designed to be deliberately ambiguous.[5] Ambiguity of legal status, however, is not a prerequisite for innovative management. Quite the contrary, ambiguity of legal status is an invitation to mismanagement and the commingling of public and private interests, generally to the disadvantage of both parties.

Government-Sponsored Enterprises

Misunderstanding of the roles and responsibilities of the public and private sectors is especially pronounced for a category of organization known as the "government-sponsored enterprise." The term, government-sponsored enterprise (GSE), has been variously defined and interpreted. Some apply the term broadly to include any entity enjoying a "non-government status and exemption from most, but not all, laws and regulations applicable to federal agencies, officers and employees."[6]

Others apply the term more narrowly. The U.S. Office of Management of Budget (OMB) presently defines government-sponsored enterprise to designate those "financial intermediaries directing capital to particular sectors of the economy."[7] The authors of this paper propose a more focused definition: a government-sponsored enterprise is a privately owned, federally chartered financial institution with nationwide scope and limited lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money.[8]

GSEs are chartered by act of Congress to accomplish public purposes. However, they are privately owned and

A category of organization referred to as the "government-sponsored enterprise" (GSE) poses a critical financial and accountability challenge to American political institutions. The largest and perhaps best known GSEs are the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). GSEs have a legal status that deliberately straddles the public and private sectors. Although privately owned for profit, GSEs can expose the U.S. Treasury--and taxpayers--to massive financial liability. Federal oversight of GSEs is fragmented and generally ineffective, thereby leaving the public's interests subordinated to private interests. The authors argue that the first step toward imposing appropriate financial and political accountability is to enact a generic GSE management law which defines the attributes of GSEs, prescribes reporting and examination requirements, and imposes restrictions on financial risk taking. A new federal agency would be responsible for GSE regulatory oversight. This article reviews the problem of GSE financial accountability, and it suggests a solution that can reassert the distinctive legal and administrative characteristics of the public and private sectors.

therefore are not considered to be agencies of the United States. Currently, seven such enterprises exist: the banks of the Farm Credit System (FCS), the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Banks (FHLB), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation (FICO) of the Federal Home Loan Bank System, and the Federal Agricultural Mortgage Corporation (Farmer Mac). Additional GSEs are being formed or are under consideration.[9]

Nothing is modest about the size and scope of these GSEs. Today, the federal government implicitly guarantees over $700 billion of enterprise obligations and mortgage-backed securities, and the value of these obligations and securities is growing rapidly. Government-sponsored enterprises have fascinated and frustrated students of public administration for some years. On the one hand, GSEs share attributes with public institutions: they are established by Congress; they issue debt obligations with most of the characteristics of federal Treasury securities; they are governed by boards that include some or all governmentally appointed directors; they have lines of credit to the federal Treasury; their obligations are implicitly guaranteed by the federal government, creating potentially open-ended claims on federal funds; they are considered instrumentalities of the federal government with charters that preempt some state laws and taxes; and, because of their federal instrumentality status, they probably cannot go bankrupt under the federal bankruptcy code.

On the other hand, GSEs also possess many of the characteristics of the private sector: they are privately owned; they sell stock to private persons and institutions; their employees are exempt from federal civil service laws; they are free to make a profit; and their operations do not depend upon regular federal appropriations.

Adding to the confusion, Congress has been inconsistent in creating GSEs. The enterprises differ, for example, in the extent they reflect cooperative principles (as with the borrower control of Farm Credit System institutions), and the extent they are profit-oriented and responsive to investor-shareholders (such as the stockholders of Fannie Mae). To take another variation, securities of the newest GSE, Farmer Mac, are subject to Securities and Exchange Commission registration requirements, while securities of the other enterprises are not.[10] Each GSE is governed by a board of directors. All of the boards have a majority of private sector members, except for Freddie Mac whose board consists of the three federal officials constituting the Federal Home Loan Bank Board.[11]

Some contend that the solution to the problem of scrambled public and private characteristics is to eliminate government-sponsored enterprises altogether. This was the view of the Reagan Administration, for example, which argued that federally supported borrowing by GSEs (and other federal credit programs) distorted the allocation of financial resources and discouraged borrowers without access to federal subsidies. Others disagree and argue that GSEs are a legitimate means of encouraging the flow of credit to favored groups--such as farmers, home buyers, students, and thrift institutions--considered not quite capable of competing with other borrowers to attract credit on appropriate terms. Whatever the merits of the debate, the federal government has increased rather than decreased the number of GSEs, and it created two new ones--the Financing Corporation of the Federal Home Loan Bank System (FICO) and Farmer Mac--in 1987.[12]

The conceptual issues posed by GSEs involve serious consequences for the federal government. If they are private, GSEs should not be controlled through direct federal management spelled out in general management laws and implemented by federal officials. Nor are traditional management tools relevant, such as statutory salary limits for executives or federal budget limitations and OMB controls. On the other hand, if GSEs have access to public funds through their ability to pledge the government's implicit guarantee to back virtually any obligations they decide to incur, then they must be regulated or supervised if the federal government is to protect itself from potentially unlimited financial exposure.

Concern over the creditworthiness of the GSEs is not misplaced. In 1988, for example, the federal government authorized $4 billion of financial assistance for one insolvent GSE, the Farm Credit System.[13] Earlier in the decade, the largest of the GSEs, Fannie Mae, was in serious trouble. Borrowing short-term money to fund its portfolio of long-term mortgages, Fannie Mae's capitalization dropped until the corporation had a negative market value net worth in 1981 of about $11 billion. Only a combination of energetic management strategies, declining interest rates, and federal support brought Fannie Mae back from the brink.[14]

What these recent episodes suggest is that there is as much need for regulation of GSEs to limit financial exposure to the U.S. Treasury as there is for effective regulation of financial institutions with federally insured deposits. Ultimately, bringing fiscal soundness to the federal government requires a good deal more than simply balancing the national budget between income and expenditures.

How Enterprises Work

Given the considerable confusion engendered by the mix of public and private attributes of each GSE, the federal government must resolve conceptual ambiguities before it can effectively supervise these enterprises. It turns out that all GSEs have a common fundamental structure despite their conspicuous differences in size, lending activities, and financial soundness.

The single most distinctive characteristic shared by all GSEs is the implicit federal government backing of their obligations and guarantees. This implicit backing allows an enterprise to borrow large amounts of money and issue large volumes of guaranteed securities at favorable rates. It also permits the enterprise to enter, and perhaps to dominate, credit markets that would not be as rewarding to independent private companies unsupported by the implicit federal backing. The scope of each enterprise's statutorily permitted activities creates an artificial segment within the general market place; its low cost of funds may enable a GSE to displace independent competitors in that market segment.

The direct obligations and some other securities issued by GSEs clearly state that they are not guaranteed by the United States, or by any agency or instrumentality of the United States other than the enterprise itself.[15] The Fannie Mae legislative charter, for example, provides that: "The corporation shall insert appropriate language in all of its obligations...clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the corporation."[16]

Despite such plain language, the financial markets perceive that the special relationship between the enterprises and the federal government is much closer than indicated by this disclaimer. The market believes that the obligations of the GSEs "presumably have *de facto* backing from the federal government."[17] Indeed, the disclaimer itself hints at a special federal relationship; completely private firms do not need to disclaim federal backing because no one believes such backing exists. The perceived relationship permits GSEs to sell their debt obligations and guaranteed securities at more favorable rates than can commercial companies without the perceived federal backing.

While the statutory characteristics vary somewhat among the enterprises, GSE securities benefit from many of the favorable attributes that are conferred by the federal government upon U.S. Treasury securities. Securities of most enterprises are exempt from registration by the Securities and Exchange Commission, their obligations are eligible to be purchased and held without limitation by national banks and other supervised institutions; their obligations are lawful investments for federal fiduciary, trust, and public funds (e.g., pension funds); their obligations can be issued and paid through the Federal Reserve System; their obligations are eligible collateral for Federal Reserve advances and discounts and are eligible to be bought and sold in Federal Reserve open-market transactions; and, for most GSEs, their obligations are exempt from state and local taxation.

Many of these benefits, such as favorable investment status for purchase by trust funds, banks, and thrifts, significantly expand the market for GSE securities. Moreover, the federal government makes a strong statement to investors by conferring upon these securities the same preferred investment status as U.S. Treasury obligations. The exemption from the usual Securities and Exchange Commission (SEC) registration laws removes investor protections considered necessary for all but the most secure federally-backed securities. Similarly, the exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally-backed securities. Investors perceive that the federal government would not permit these exemptions from basic investor protection unless the securities were extremely safe.

Over time, the market can become even more confident about the government's likelihood of backing obligations of government-sponsored enterprises. As the value of outstanding GSE obligations increases so does the inability of the federal government to intimate that it would not stand behind this debt. The Comptroller of the Currency defended the federal protection of creditors of the Continental Illinois Bank by noting that, because of their size alone, the federal government simply cannot permit the failure of any of the nation's largest money-center banks.[18] This logic applies with even more force to government-sponsored enterprises; Fannie Mae, the Federal Home Loan Banks, and the Farm Credit System are significantly larger than many money-center banks.

Government-sponsored enterprises have another important common characteristic; by law they are confined to a narrow range of lending activities. Unlike completely private financial institutions that can grow by diversifying into a wide range of credit markets, GSEs are restricted to specific kinds of borrowers and often to particular kinds of loans. Fannie Mae and Freddie Mac are limited to providing a secondary market for residential mortgage loans below a specified size, currently $187,600. Farm Credit System institutions and the new Federal Agricultural Mortgage Corporation (Farmer Mac) are limited to specified kinds of agricultural lending; the Federal Home Loan Banks are limited to providing credit to thrift institutions; the Financing Corporation (FICO) is limited to purchasing FSLIC securities; and Sallie Mae is largely limited to education-related lending.

Because of their low borrowing costs and the benefits of their national charters, GSEs can grow quite rapidly. In 1987, Fannie Mae's lending expanded by $47 billion, to a total $243 billion by the end of the year. Sallie Mae, one of the smaller enterprises, grew 25 percent in size in 1987, from $18.2 billion to $22.9 billion in assets. Altogether, enterprise securities outstanding, including debt and mortgage-backed securities, rose from $9 billion in 1967 to $96 billion in 1977, to $661 billion in 1987. Outstanding GSE securities are increasing by an estimated $70 billion to $100 billion per year. Because of their access to inexpensive federally-supported credit, GSEs tend to grow quickly to dominate their statutorily permitted markets.

GSEs as Instrumentalities

The federal government's control over an institution differs significantly depending on whether that institution is an agency or instrumentality. The government manages an agency directly through the federal management hierarchy. As a general rule, an agency is subject to federal appointment of its senior officers, to civil service and federal procurement laws, and to the federal budget and other direct federal management controls. By contrast, an instrumentality is a privately owned institution that is supervised but not directly managed by the government.

What, precisely, are GSEs, and how do they relate to the larger organization of the executive branch? The answer to this question is that a GSE, as previously noted, is an "instrumentality" of the United States, not an "agency." This distinction is critical and provides the basis for developing a regulatory structure for GSEs.

Under law, an "executive agency means an executive department, a government corporation, and an independent establishment."[19] As such it is the organizational term with the most encompassing definition. Conceptually, an entity is either an agency of the United States, or it is something else. For an entity properly to be considered an agency of the United States, it must have been created pursuant to law, be considered an arm of the sovereign power with authority to act with the force of law, and be subject to all the laws applying to "agencies" except where exempted in a general managerial statute or in its enabling statute. Once again, statutory variations exist designating institutions to be agencies for purposes of some laws but not others.

The concept of an "instrumentality," by contrast, generally lacks definition in federal statute, but it has content nonetheless. An instrumentality is a privately-owned institution that may be supervised but is not directly managed by the federal government. The federal government uses an instrumentality to carry out governmental purposes in addition to usual private purposes such as profit making for its private owners.

An instrumentality benefits from federal law that preempts state laws and taxes to the extent Congress prescribes. Unlike an agency, an instrumentality does not act with the power of the state. Rather, it is a private institution with authority to perform specified functions (e.g., providing credit to a designated economic sector) that are considered to embody public purposes. Significantly, a GSE typically is governed by a board of directors with a legal and fiduciary responsibility to the private stockholders and not to the federal government.

This clear distinction between "agency" and "instrumentality" is crucial although frequently violated in practice. The blurring of the proper boundaries between the public and private sectors arises from a variety of causes. Proponents of legislation establishing an instrumentality, for instance, may seek provisions providing some of the benefits of agency status, such as an exemption from antitrust laws. Conversely, Congress may seek to confer some of the benefits of instrumentality status upon executive agencies, such as exemptions from civil service personnel and salary restrictions.

The authors maintain that GSEs are a distinct kind of instrumentality amenable to a generic law governing important aspects of their organization, attributes, authority, and finances relating to the government's contingent liability from GSE operations.

Generic Laws as Tools of Administration

The underlying premise of this analysis is that in a democratic polity, all organizations assigned public benefits and public purposes by law should be accountable for their performance to elected leaders. Ideally, lines of accountability should be direct and unambiguous. Accountability of agencies of the United States is generally enforced by direct management command. For instrumentalities, however, accountability is indirect, and it is generally achieved through external regulation rather than direct federal management.

Whether the performance of a public function be by agency or instrumentality, public accountability is best promoted through a generic law. Today the federal code contains between 100 and 150 generic management laws depending on the definition employed. Many laws, such as the Anti-Deficiency Act or the Prompt Payment Act, fall within the responsibility of OMB.[20] Other agencies are also responsible for implementing generic management laws; for example, the U.S. Office of Personnel Management (OPM) administers the civil service laws, the U.S. General Services Administration (GSA) implements some federal procurement laws, and the U.S. Department of Labor administers the Federal Employee Compensation Act. The generic management laws, taken together, provide a framework within which Presidents can, if so disposed, shape the direction of management of the federal government, and--often to a lesser extent, depending on the relevant law--the direction of the "quasi government."

The President and Congress share responsibilities for overseeing the management of the Government and its agencies and instrumentalities. Management is more than simple control; it is also capacity building. Management laws, interpreted and administered with care, should permit the agency or instrumentality to perform its public responsibilities more effectively, not just more economically. Generic laws, properly written, provide a means to implement a comprehensive managerial strategy. In 1945, for example, Congress and the President enacted the Government Corporation Control Act to address the problem of managing the proliferation of government corporations resulting from the Depression and World War Two.[21] This important act reflected a theory of what a government corporation ought to be legally, structurally, and financially.[22] The act provided a framework for federal management, thereby focusing the oversight process on the need for questions whether a particular government corporation needed exemptions from general coverage because of special circumstances.

By framing the important issues in advance, a generic management law can greatly improve the quality of political discourse concerning federal supervision and oversight. Without a generic law, each institution and set of circumstances tends to be addressed on an ad hoc basis. In the absence of a framework of principles, a regulator or supervisor finds it difficult to impose accountability, especially if opposed by parties interested in lax oversight. A generic management law can help to shift the political debate to questions about whether exceptions to general rules are warranted. In a debate over exceptions, the advantage tends to shift to the agencies and the oversight committees in Congress which are most concerned with overall government management and away from more particular interest group constituencies.

The authors here contend that a generic law is especially important to promote accountability by instrumentalities that are free from direct federal management controls. While a generic law is not a guaranteed means of assuring accountability, it is superior to efforts at imposing accountability through ad hoc legislation.

National Banks as Precedent

Hundreds of failed thrift institutions today testify that the mere fact of a generic law by itself cannot protect the government against mismanagement and financial exposure. The substance of that generic law is also essential. By contrast to the unfortunate Federal Home Loan Bank Board--statutorily required to promote the thrift institutions that it is supposed to regulate--the regulation of national banks provides a more promising precedent.

National banks are a major category of federal instrumentality. They are governed under a generic law known as the National Bank Act.[23] Under that act, the Office of the Comptroller of the Currency (OCC) in the Department of the Treasury charters national banks and supervises their financial safety and soundness. The experience of this regulator under the generic law provides a valuable model for regulating GSEs.

National banks and GSEs share important characteristics. Both are chartered by the federal government. Their federal enabling legislation preempts some state taxes and a number of state laws. Banks are expressly ineligible and GSEs are probably ineligible for bankruptcy under the federal bankruptcy code. Finally, and perhaps most importantly, the implicit federal guarantee of GSE borrowing resembles federal deposit insurance that permits national banks to obtain low-cost funds from depositors. As with the virtually unlimited federal risk exposure from the implicit guarantee of enterprise borrowing, the federal government also faces a multi-billion dollar financial exposure from its informal guarantee of the federal deposit insurance funds.

Both GSEs and national banks share common characteristics with the earliest federally chartered financial institution, the first Bank of the United States. That bank was authorized to serve the entire nation and to make virtually all kinds of loans.[24] Government-sponsored enterprises feature the former characteristic (nationwide scope) and national banks the latter (virtually unrestricted kinds of loans). Because of these common characteristics, GSEs and national banks share a common body of federal case law, descending from the earliest cases involving the first and second Banks of the United States.[25]

One major difference remains between the national banks and government-sponsored enterprises; the former are regulated under the authority of a generic law while the latter are not.

A Generic Law for Government-Sponsored Enterprises

The authors propose passage of a "Government-Sponsored Enterprises Financial Accountability Act" combining conceptual elements of the National Banking Act and the Government Corporation Control Act to provide the necessary guidelines for the organization and financial oversight of GSEs. This legislation would establish common financial controls and structural elements applicable to each GSE, and it would create the statutory framework for uniform federal supervision of enterprise safety and soundness.

This law would include a number of provisions designed to improve the accountability of GSEs to federal officials responsible for supervising enterprise safety and soundness. This accountability is important to help limit the government's financial exposure for GSE obligations. The law would structure each enterprise within an essentially uniform financial framework designed to protect against excessive federal risk exposure.

Second, the law would build upon lessons learned from the regulation of national banks (and from mistakes in the federal regulation of thrift institutions), and it would establish a central regulator to examine, supervise, and enforce requirements relating to financial safety and soundness. Third, because the GSEs differ significantly among themselves in the types of benefits they are designed to provide, and in recognition of the system of congressional committees with a stake in overseeing all federal credit programs within their political jurisdictions, the allocation of the benefits of GSE lending activities would not be covered by the generic law and would instead be left to congressional oversight and supervision.[26] Finally, the law would remove administrative anomalies, such as control of Freddie Mac by a board of directors consisting of federal officials and its other federal agency characteristics, and it would specify that GSEs are instrumentalities, not agencies of the United States.

Office of Comptroller of Government Enterprises

Today, where GSEs are regulated, the regulators generally lack sufficient resources to supervise the finances of these multi-billion dollar institutions; a GSE regulator such as the U.S. Department of Housing and Urban Development is neither oriented to nor staffed for proper supervision of the safety and soundness of a huge financial institution such as Fannie Mae. Also, their regulatory mandate is vague, and this has led several regulators to slight safety and soundness in favor of other policy goals. This state of affairs is inadequate to protect the federal government and taxpayers from undue financial exposure. The proposed GSE Financial Accountability Act would address these problems by providing that GSEs be supervised in a manner similar to current federal oversight of national banks.

One important feature of enterprise regulation would be the delegation to a single administrative agency headed by a single administrator the authority to regulate, examine, and enforce compliance through appropriate measures to assure safety and soundness. The GSE regulator might be, and should be, located within the Treasury Department because of that Department's expertise in financial matters; it is within the Treasury Department that the regulator of the national banks, the Comptroller of the Currency, is housed.[27]

Operating in much the same manner as the Office of the Comptroller of the Currency (OCC), the centralized GSE regulator might be called the Office of the Comptroller of Government Enterprises (OCGE). It would develop long-term expertise in assessing and regulating the financial soundness of GSEs. Especially important, the OCGE could apply lessons learned from supervising one GSE to another and, in so doing, could provide guidance to Congress about structuring proposed new enterprises. Statutorily, each GSE would no longer be treated *sui generis*. Indiscriminate blurring of public and private characteristics would be discouraged if not prevented. Recognition that GSEs can be supervised as a category of organization rather than attempting to develop regulatory structure and processes for GSEs individually is the necessary first step toward public accountability in this crucial field of public policy.

A Theory of Enterprise Safety and Soundness

Because the federal government's guarantee removes much of the usual market discipline, effective government regulation is essential to help contain enterprise risk taking and to help assure its long-term viability.[28]

Regulation is not an assured solution for problems caused when the government's implicit guarantee distorts normal market incentives. Failure of the Continental Illinois Bank provides a recent example of the fact that regulation is not complete protection against risk exposure of the federal government. Nevertheless, absent untried substitutes such as risk-related federal insurance premiums, a strong case exists for regulation of GSEs as a partial substitute for insufficient market discipline.

What are the elements of effective GSE regulation? To begin with, it is essential that the regulatory agency be capable of overseeing safety and soundness and that the regulator not have conflicting motivations that could impede effective regulation to this end. Given a capable and properly motivated regulator, the form of safety and soundness regulation follows logically from the federal government's role as implicit guarantor. Efficient government regulation should resemble the measures adopted by a private guarantor imposing controls on a firm whose obligations it guarantees or by a private lender overseeing the credit worthiness of a borrower.[29]

Reporting and Examining Risk Exposure

Effective federal supervision of GSE safety and soundness should include prompt and accurate financial reporting by each GSE, periodic detailed financial examination by the regulatory agency and a variety of statutory limitations and regulatory controls on financial risk-taking.

Each enterprise should be required to provide an annual report of condition to the OCGE, much as is provided by national banks to the Comptroller of the Currency. Such reports should include assessment of the risks, e.g., credit risk, interest rate risk, and business risk, relating to purchased loans as well as GSE contingent liabilities.

GSE reports should be supplemented by periodic examination of enterprise operations by the OCGE. Examination permits the regulator to investigate the policies and procedures used by the enterprises to assure financial soundness. Examination can address management practices relating to asset quality, interest rate exposure, management information and control, and other aspects of enterprise risk taking. Examination should be conducted within a framework of OCGE regulations and policy statements defining some of the important standards of safety and soundness to be met by each GSE. In addition, examiners would be empowered to monitor and require correction of any other GSE activities and conditions involving unnecessary risk exposure.

Statutory and Regulatory Controls on GSE Risk Taking

The 1980s have provided the federal government with significant lessons on the need for effective control on financial risk taking by federal instrumentalities. The most important lessons can be summarized as follows. First, institutions must maintain sufficient capital so that the private owners have their own money at stake and are not merely taking risks at the taxpayers' expense. Capital requirements should be imposed on a risk related basis; as an institution increases its credit risks or interest-rate risks or operating risks, the private owners should meet increasingly higher capital requirements. These capital-adequacy requirements must apply to financial activities whether or not they appear on the institution's balance sheet. For a GSE, for example, risk-based capital requirements would attach to the volume of business and risks involved in issuing its guaranteed mortgage-backed securities as well as holding loans in its portfolio.

Second, if net worth drops below prescribed standards, the OCGE should be empowered to impose appropriate controls on the institution's activities. An array of regulatory prior approval requirements, adapted from the Fannie Mae charter act, could be used for this purpose. These controls would include the authority to deny payments of dividends to shareholders, to prohibit growth of lines of business that the regulator considers risky, and to require reduced risk from ongoing activities. If net worth declined below a specified level, the regulator could also be empowered to remove directors and officers of the GSE, as the OCC is currently authorized to do with respect to national banks.

The regulator would also have the other enforcement powers available to the OCC, such as authority to issue cease and desist orders, and authority to impose civil penalties on enterprises and their directors and management.[30] Finally, the regulator would be empowered to appoint a conservator or receiver for a financially troubled enterprise under authority patterned on the authority of the OCC to deal with troubled national banks.

Directors of Government-Sponsored Enterprises

Although GSEs are instrumentalities of the United States, they are privately owned and therefore require a board of directors accountable to their private owners. From the time of the second Bank of the United States, however, the federal government has appointed some members to the boards of a variety of instrumentalities.

When the government appoints directors of a private company, this can engender considerable confusion as to their proper role and legal obligations. Even when the President appoints such government directors, they are not considered to be officers of the United States.[31] Should they represent the views of the Administration that appointed them, the "public interest," even if in conflict with Administration policy, or the financial interests of the corporation and its private owners?[32]

On balance, the legal and political ambiguity inherent in the role of a governmentally appointed member of a board of a privately-owned corporation makes such an appointment of dubious value. Indeed, such appointees may give the impression of governmental participation and approval of corporate decisions that is unlikely to be the case in fact.[33] "Of all the means available to exert government influence and safeguard the public interest," Harold Seidman observes, "presidential appointment of directors is probably the least effective."[34]

The GSE Financial Accountability Act proposed here would provide that all GSE directors be elected by the shareholders. The Comptroller of Government Enterprises would be empowered to remove those GSE directors under statutory authority similar to that available to the Comptroller of the Currency.

Additional OCGE Authorities

As privately-owned instrumentalities, GSEs are entitled to create subsidiaries, to merge all or part of their organization with another organization, and to dissolve their corporation unless prohibited from doing so by their enabling legislation. The Comptroller of Government Enterprises should develop rules and regulations governing such actions by GSEs to insure that the federal government's financial interests are protected in such cases.

The GSE Financial Accountability Act, again taking its cue from the Fannie Mae charter, should provide the OCGE with general regulatory authority. The Fannie Mae legislation provides that the regulator, the U.S. Department of Housing and Urban Development (HUD), "shall have general regulatory power over the Federal National Mortgage Association and shall make such rules and regulations as shall be necessary and proper to assure that the purposes of this title are accomplished."[35]

This general regulatory authority is important to empower the regulator to fill in gaps in the otherwise sparse language characteristic of most federal charters. It is also important, along with the other regulatory powers, to enable the regulator to exert subtle leverage on GSEs (which may be very large financial institutions), without having to rely upon more draconian measures that could disrupt the financial markets. Such leverage is important in the relationship of federal regulators to national banks, and the similarities here appear persuasive.[36]

No doubt a fine line exists between too little and too much federal regulatory intervention in the activities of GSEs. The GSE Financial Accountability Act should include legislative guidance clarifying that the OCGE should not become involved in day-to-day managerial or operational decisions of a GSE except as these relate to the institution's safety and soundness and its compliance with the law. As a GSE drops in net worth or increases risk exposure, the degree of OCGE involvement in GSE management decisions would increase. Again, the relationship between the Comptroller of the Currency to the national banks provides an appropriate legislative and practical model.

Conclusion

Government-sponsored enterprises have become not only a financial challenge to political leaders but also a management and accountability challenge. Today, they function in the twilight zone between the public and private sectors with little systematic oversight by either the executive or the legislative branches. Efforts to impose upon GSEs the appropriate degree of accountability to federal agencies and to Congress have so far failed, partly because there is no generally accepted theory of how best to regulate these federal instrumentalities to promote the public interest.

The President must be considered at least partially responsible for the policies and operations of GSEs. While GSEs may not have their financial dealings directly reflected in the budget, the contingent liabilities incurred by these instrumentalities cannot help but influence the health of the economy generally and, as in the case of the recent bailout of the Farm Credit System, sometimes directly affect the federal budget itself. Yet the President and the executive branch have little legal authority or institutional capacity to affect the policies of GSEs. The authors contend that the first step toward resolving this discrepancy between political responsibility and institutional capacity is to enact a generic law providing for comprehensive regulation of GSEs and clarifying their status as instrumentalities rather than agencies of the United States.

The premier tool for managing the public sector and the "quasi government" is public law. Depending on its content, public law can help to solve or exacerbate a problem. The proposed GSE Financial Accountability Act would rest on basic principles of constitutional and public management theory. The distinctive legal character of the public and private sectors would be maintained and protected. The relationship and responsibilities of the two sectors would be spelled out with as much precision as possible, and provisions would be applied as a generic law to the various GSEs.

Generic laws are not appropriate for all public management problems. They are most effective when a specific management problem cuts across a number of agencies or instrumentalities. The choice is either to approach each agency or instrumentality on an individual basis, inserting in the enabling legislation the desired language, or to write a general set of rules and assign their implementation to a central management agency. This latter approach is favored when the regulation is based on common principles that can be implemented without detracting from the intended, unique qualities of each regulated instrumentality. The regulation of financial soundness of GSEs meets this test.

The Government-Sponsored Enterprises Financial Accountability Act, properly drafted, would serve several critical public purposes. First, it would provide for a degree of regulatory accountability by GSEs in their practices that result in federal financial exposure. Second, it would recognize and define the role of federal instrumentalities as agents to carry out statutorily defined public purposes. And third, it would provide for the President and the designated federal regulatory agency the legal authority and institutional capacity to help assure that the privately-owned GSEs are regulated in a manner consistent with public administration principles and sound financial management practices.

Ronald C. Moe is a Specialist in Government Organization and Management with the Congressional Research Service of the Library of Congress. His writings include *The Hoover Commissions Revisited* (1982) and articles in such journals as *PAR*, *Political Science Quarterly*, and *Presidential Studies Quarterly*. He is a Fellow of the National Academy of Public Administration.

Thomas H. Stanton is a Washington, DC, attorney. His recent writings include "Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy," published in 1988 by the Association of Reserve City Bankers. He is currently working on a variety of matters related to government-sponsored enterprises and federal credit programs.

Notes

1. Ronald C. Moe, "Liabilities of the Quasi Government," *Government Executive*, vol. 20 (November 1988), pp. 47-50.
2. Lloyd Musolf and Harold Seidman, "The Blurred Lines of Public Administration," *Public Administration Review*, vol. 40 (March/April 1980), pp. 124-130.
3. See, for example: Barry Bozeman, *All Organizations Are Public: Bridging Public and Private Organizational Theories* (San Francisco: Jossey-Bass Publications, 1987). Mark A. Emmert and Michael M. Crow, "Public, Private and Hybrid Organizations: An Empirical Examination of the Role of Publicness," *Administration and Society*, vol. 20 (August 1988), pp. 216-244.
4. See, for example: Ronald C. Moe, "Exploring the Limits of Privatization," *Public Administration Review*, vol. 47 (November/December 1987), pp. 453-460. Harold J. Sullivan, "Privatization of Public Services: A Growing Threat to Constitutional Rights," *Public Administration Review*, vol. 47 (November/December 1987), pp. 461-467.
5. Harold Seidman, "The Quasi World of the Federal Government," *The Brookings Review*, vol. 6 (Summer 1988), pp. 23-27.
6. Ibid., p. 25.
7. U.S. Office of Management and Budget, *Special Analyses: Budget of the United States Government, Fiscal Year 1990* (Washington: U.S. Government Printing Office, 1988), p. F-21.
8. Thomas H. Stanton, *Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy* (Washington: Association of Reserve City Bankers, 1988), p. iv. This definition excludes a variety of institutions that share some characteristics with GSEs. For example, the College Construction Loan Insurance Corporation (Connie Lee) is not a GSE because it is partly government owned; the Farm Credit System Financial Assistance Corporation is not a GSE because its securities are expressly, and not merely implicitly, guaranteed by the federal government.
9. For example, in 1986 the House of Representatives passed legislation to create a new GSE called the Corporation for Small Business Investment (COSBI) to fund small business investment companies. See Thomas H. Stanton, "Pending Legislation Would End Impasse Over SBA Program," *Legal Times* (October 6, 1986), p. 24. On February 6, 1989, the Bush Administration proposed creating a new GSE, the Resolution Funding Corporation, to provide an off-budget conduit for funding the insolvent Federal Savings and Loan Insurance Corporation.
10. Compare 12 U.S.C. 2279aa-12(a) of the Farmer Mac charter act with 20 U.S.C. 1087-2(d) of the Sallie Mae charter act, for example.
11. 12 U.S.C. 1452 specifies that Freddie Mac's Board of Directors consist of the three members of the Federal Home Loan Bank Board. The three members of the Bank Board are the Chairman and two members, each appointed by the President and confirmed by the Senate. 5 U.S.C. App. 1, Reorg. Plan No. 3 of 1947, Sec. 2 Conceptually and legally, this direct federal control probably makes Freddie Mac an agency of the United States, not an instrumentality. The Freddie Mac charter also includes other characteristics that are normally associated with agency status such as the provision that "the corporation shall be entitled to all immunities and priorities...to which it would be entitled if it were the United States or if it were an unincorporated agency of the United States." Yet, other provisions of the charter legislation exempt the enterprise from civil service and procurement and other requirements normally applicable to an agency.
12. For an informed discussion of the role of both "market failure theory" (private sector) and "non-market failure theory" (public sector) as catalysts to public policy decisions, consult Charles Wolf, Jr., *Markets or Governments: Choosing Between Imperfect Alternatives* (Cambridge: MIT Press, 1988).
13. U.S. Office of Management and Budget, *Special Analyses: 1990*, pp. F-23 to F-26.
14. See, e.g., U.S. Department of Housing and Urban Development, "1986 Report to Congress on the Federal National Mortgage Association" (Washington: U.S. Government Printing Office, 1987), pp. 87-112.
15. By contrast, the federal government expressly pledges its full faith and credit to back securities guaranteed by the Government National Mortgage Association (Ginnie Mae). 12 U.S.C. 1721(g)(1). Ginnie Mae is a wholly-owned government corporation within the Department of Housing and Urban Development and thus is an agency rather than an instrumentality of the United States.
16. 12 U.S.C. 1719(b).
17. Marcia Stigum, *The Money Market*, rev. ed. (Homewood, IL: Dow Jones-Irwin, 1983), p. 212.

18. Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues* (New York: Basic Books, 1986), p. 259.

19. 5 U.S.C. 105.

20. For an overview of the generic management laws administered by the U.S. Office of Management and Budget, consult U.S., Congress, Senate, Committee on Governmental Affairs, Office of Management and Budget: Evolving Roles and Future Issues. Prepared by the Congressional Research Service, S. Print 99-134. 99th Cong., 2d sess. (Washington: U.S. Government Printing Office, 1986), pp. 395-675.

21. 31 U.S.C. 9101-9.

22. Sidney D. Goldberg and Harold Seidman, *The Government Corporation: Elements of a Model Charter* (Chicago: Public Administration Service, 1953). National Academy of Public Administration, *Report on Government Corporations*, 2 vols. (Washington: National Academy of Public Administration, 1981).

23. 12 U.S.C. 1 et seq.

24. "An Act to incorporate subscribers to the Bank of the United States," approved February 25, 1791, 1 Statutes at large, 191. See also Bray Hammond, *Banks and Politics* (Princeton: Princeton University Press, 1957).

25. The case law for both kinds of institutions stems from two major U.S. Supreme Court decisions: *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819) and *Osborn* v. *Bank of the United States*, 22 U.S. (9 Wheat.) 738 (1824).

26. Issues involving the allocation of benefits appear to be difficult for GSE regulators to handle. In one well publicized instance, the Secretary of the Department of Housing and Urban Development tried but failed to intervene in Fannie Mae lending policies and decisions. The Secretary wanted to alter Fannie Mae's policies so as to increase its lending to central city and low-income home buyers. See U.S. Department of Housing and Urban Development, "1986 Report to Congress on the Federal National Mortgage Association," pp. 162-166.

With respect to the scope of GSE lending authority, the financial regulator proposed here should be limited to assuring that the enterprise complies with the laws and does not engage in ultra vires acts.

27. Note that it would not be appropriate to centralize financial regulation of GSEs within the U.S. Office of Management and Budget because OMB's authority relates to federal management and the federal budget rather than oversight of privately-owned, off-budget institutions such as government-sponsored enterprises.

28. Extensive literature exists on this point concerning a variety of financial institutions with borrowing implicitly backed by the federal government. See Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," *Business Review* (Federal Reserve Bank of Philadelphia, January/February 1982), pp. 17-27. Fischer Black, Merton H. Miller, and Richard Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business*, vol. 51 (1978), pp. 379-412. Sherman J. Maisel, ed., *Risk and Capital Adequacy in Commercial Banks* (Chicago: University of Chicago Press, 1981), chapter 6.

29. Black, Miller, and Posner, "An Approach to the Regulation of Bank Holding Companies," p. 382.

30. See 12 U.S.C. 1818(e). This section provides a variety of grounds for the regulator to remove directors and officers of a national bank.

31. See memorandum of U.S. Attorney General Robert Kennedy, "Memorandum Re Constitutionality of Senate Confirmation of Persons Nominated by the President as Incorporators and Directors of the Communications Satellite Corporation," *Congressional Record*, vol. 109, pt. 5 (88th Cong., 1st sess., 1963), pp. 6977-6978.

32. A study of an instance when Congress provided for governmental directors on the board of a private corporation, the Communications Satellite Corporation, led Herman Schwartz to conclude:

> Both the practicalities of life and the lessons of history lead to the conclusion that the appointment of government directors to a private board cannot protect the public interest against private abuse. Moreover, such directors may even be instruments of harm to other aspects of the public interest. Their presence may reinforce the belief that the Government assures the profitability of the corporation....

Herman Schwartz, "Governmentally Appointed Directors in a Private Corporation: The Communications Satellite Act of 1962," *Harvard Law Review*, vol. 79 (December 1965), p. 363.

33. GSEs may actually work to increase the identification of their public directors with the interests of the stockholders rather than the public. Fannie Mae, for intance, has a generous stock plan available for presidentially appointed directors. The plan provides, simply described, for $30,000 in stock to be given to "non-employee members" of the Board over a five-year period. The intent of this generosity is to "reinforce the mutuality of interest between such directors and the company's stockholders." Fannie Mae, "Proxy Statement Dated March 27, 1987," Appendix C, page C-1. As reported in Stanton, *Government Sponsored Enterprises*, p. 26.

34. Harold Seidman, *Politics, Position and Power*, 3d rev. ed. (New York: Oxford University Press, 1980), p. 293.

35. 12 U.S.C. 1723(h).

36. Carter H. Golembe and David S. Holland, *Federal Regulation of Banking* (Washington: Colembe Associates, Inc., 1986), pp. 231-232.

The CHAIRMAN. Well, that is a very, very interesting statement you have given us, and it raises a number of, I think, important points and concerns, and I very much agree with the notion that we now need to understand effects that have been set in motion by the FIRREA legislation that may in fact create other possible problems, even if unintended. We will take a very careful look at that.

I appreciate the comment along that line.

It also raises a question in my mind, do we need to think about real minimum capital standards for all the GSE's? I will come back to that in a minute.

Mr. Carron, we are pleased to have you and would like to hear your comments now.

STATEMENT OF ANDREW S. CARRON, DIRECTOR, FIXED INCOME RESEARCH, FIRST BOSTON CORP., NEW YORK, NY

Mr. CARRON. Thank you, Mr. Chairman. I am pleased to have the opportunity once again to testify before this committee on matters of importance to the financial markets.

The government-sponsored enterprises have been and continue to be a positive force in promoting the integration of capital markets and assuring access of local borrowers to broader markets. The standardization of loan contracts and the development of secondary resale markets have also increased the liquidity of financial instruments such as mortgages and student loans. These are the public purposes that the GSE's were created to serve.

The GSE's links to the federal government provide certain advantages, and these are counter-balanced by charter restrictions, government oversight, and public interest activities. This mixture of private ownership, which provides incentives to innovate and minimize costs and public policy has generally worked quite well.

Much of the recent focus on the GSE's has been motivated by the crisis in the S&L industry. I studied the thrift industry extensively. I testified before this committee seven years ago when it was considering Garn-St Germain, and I was one of the first witnesses earlier this year when you were reviewing the legislation that ultimately became FIRREA. I have also analyzed the GSE's and co-authored a study published by the Brookings Institution two years ago.

As one who predicted the failure of hundreds of S&Ls as early as 1981, I am certainly not reluctant to point out incipient crises. However, on the basis of the work that I have done, I do not believe the S&L crisis provides much guidance for policy with respect to the GSE's. The GSE's are substantially different in terms of mission, operation, financial structure, prudential incentives, and regulation.

Of course, there are risks facing the GSE's as with virtually any enterprise, public or private, but these risks should be evaluated on their own terms, as they are not a logical extension of the thrift situation.

Most financial institution risk can be managed. Interest rate risk is minimized by matching assets and liabilities. Credit or default risk is controlled through geographical diversification of assets, careful underwriting, avoidance of excessive volatile investments, and reinsurance.

Risk exposure can be quantified as part of the management process, and then management's job is to build reserves against loss and to avoid circumstances that could endanger the continued viability of the enterprise.

Of course, more protection against possible loss implies reduced service, higher prices, or both, and those can hit hardest at the most needy recipients. So the task for the GSE's and for those overseeing them is to identify the benefits and risks and to determine the appropriate level of cost and risk exposure.

It would be premature at this point to form a judgment as to the appropriateness of the GSE's current risk return balance. I think the studies being conducted by the Treasury and the GAO, in conjunction with data and analyses from the enterprises themselves, will provide a basis for such conclusions.

When evaluating the risks of the GSE's, it is important to keep in mind that these entities were chartered to meet certain societal goals. Two risks faced by the GSE's that fully private firms can avoid are, first, the counter-cyclical assistance role that their mandates require and, secondly, their consequent inability to diversify out of existing lines of business and into new lines of business as new opportunities present themselves.

In fact, in the event of a serious recession or the threat of another depression, the government-sponsored enterprises will probably be seen as a means of restoring stability and reviving economic activity in housing, agriculture, education, and the other sectors that they are charged with serving.

Indeed, in the event of a serious crisis, government policy would move to stabilize all important sectors of the economy, not only those where the GSE's exist. So there is in effect an implied guarantee for the economy as a whole. In this context, the implicit guarantee of agency status does not constitute a large subsidy and differs only modestly from the implied guarantee against failure in any critical sector of the economy.

Federal assistance to the GSE's required by an economy-wide crisis would be motivated by a desire to revive economic activity rather than by any implied guarantee of creditworthiness.

The special status that investors in the fixed income markets accord U.S. agency issues arises from several sources. I believe it is incorrect to focus only on the widely held belief that the federal government would intervene to prevent bondholder losses in the case of a major collapse. I think equally important is the perception that federal government policy ensures the continued health of these enterprises through the oversight process. Another factor often overlooked is that GSE's are immune from leveraged buyouts and other forms of event risk that can quickly alter the credit rating of even a high quality private enterprise.

Investors are generally willing to accept a lower interest rate on GSE debt than on purely private debt, all other things being equal. Under ordinary circumstances, however, the agency status is an incremental, not absolute credit enhancement. The financial health of the entity, independent of government support, does enter into the investor's decision.

I would note parenthetically at this point that Mr. Gillis referred to the credit rating of the senior debt of Fannie Mae, but when you talk about the debt of the GSE's, particularly Fannie Mae and Freddie Mac and some of the others, most of that consists of secured debt, asset-backed, mortgage-backed securities, and these would typically have a different and generally higher credit rating. So perhaps that is a subject that you might want to explore with the rating agencies.

One does see a substantial variation in interest rates on similar debt across the GSE's, and a given entity will pay different rates at different points in time as it is perceived financial condition varies. So the existence of an implicit guarantee does not remove the incentive that these enterprises have to operate in a safe and profitable manner.

GSE securities are accorded lower weights in the bank risk-based capital guidelines than the underlying loan assets for reasons other than agency status. The GSE issues are securities, not direct liabilities of individuals, and this gives them less risk, because they are standardized, they are marketable, and they can be separated from the loan servicing activity.

Moreover, because risk is a portfolio concept and not only an attribute of the individual assets, it is possible to reduce overall financial risk through the asset transformation and diversification activities of the GSE's. So the lower risk weights of the GSE securities do imply a reduction in overall risk rather than a transfer of risk within the economy.

The GSE's help recycle capital market resources, stabilize financial markets, correct market imperfections, and provide a source of innovation. Although the private sector has assumed some of the original activities of these entities, the GSE's still have a vital role to play in the financial system. Assessments of the risk exposure of the GSE's are appropriate, but should be conducted in the context of the GSE's mission in the economy and the cost of marginal reductions in risk exposure.

Thank you.

[The complete statement of Andrew S. Carron follows.]

Statement of

Andrew S. Carron
Director - Fixed Income Research
First Boston Corporation
New York

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

October 31, 1989

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to testify on the government sponsored enterprises (GSEs). I co-authored a study of these programs while a senior staff member in the economic studies program of the Brookings Institution. I am currently manager of mortgage research in the Fixed Income Research Department of the First Boston Corporation, where my responsibilities include the analysis of mortgage securities issued or guaranteed by government sponsored enterprises.

At the Committee's request, I am appearing today as an industry expert. I will express my personal views only as I am not appearing on behalf of First Boston.

My comments will seek to provide a framework for evaluating the government sponsored enterprises. A more detailed review, including analyses of specific programs, may be found in the aforementioned study, The Economics of Federal Credit Programs, written with Barry Bosworth and Elisabeth Rhyne.

The mechanisms by which these programs perform their missions are complex and not widely understood. Moreover, the volume of credit passing through the GSEs is large in relation to the financial system as a whole, and several market sectors are heavily reliant upon them. Their importance to the economy thus clearly justifies the attention of this Committee and the executive branch agencies. The appropriate basis on which to evaluate the GSEs is whether they are continuing to provide credit to those areas of the economy in accordance with longstanding public policy. My conclusion is that the GSEs remain an efficient and effective means of meeting important societal objectives.

Role of the Government Sponsored Enterprises

The initial involvement of government in credit markets was triggered by the financial collapse that accompanied the Great Depression. Early programs were aimed at stemming further declines and providing relief to institutions and individuals that had already suffered losses. The emphasis then shifted toward correcting perceived failures of private capital markets and developing mechanisms to ensure that the financial system would be safe from another collapse. Today the largest volume of activity continues to be concentrated in those sectors that were singled out for attention in the 1930s, primarily housing and agriculture, although the programs have been restructured over the years to meet changing needs.

Private capital markets have evolved in ways that make them far more capable of serving the diverse needs of private borrowers than they were half a century ago. The existence of an international capital market and the broadening of the institutional investor base have increased the liquidity of financial assets and has made it possible to absorb financial risk through portfolio diversification in ways that were not possible in the 1930s.

The government sponsored enterprises are a positive force in stimulating these innovations. Such efforts have been particularly useful when the entity has aimed at promoting an integration of capital markets and assuring access of local borrowers to broader markets. The standardization of loan contracts and the development of secondary resale markets have also increased the liquidity of specific financial instruments, such as mortgages and student loans.

Government sponsored enterprises are typically owned and financed by the private sector. Their links to the government take the form of assurances of support in severe crises in return for responsibility for operating in accord with national goals. The mixture of private ownership, which provides a motive to innovate and minimize costs, with a public policy orientation has generally worked well. Thus the advantages that come with GSE status are counterbalanced by charter restrictions, government oversight, and public interest activities.

As private institutions have developed in these markets (often following the patterns established by the government sponsored enterprises), the GSEs' links with the government have been reviewed and modified. The current status of these links is shown in table 1. In the past, the GSEs received some direct subsidies, but these have been largely eliminated.

The government sponsored enterprises continue to play an important role in the economy. They are still needed because of remaining barriers to the free flow of capital in the financial system. They provide a source of innovation and a means of extending credit to borrowers who would not otherwise be served, with or without subsidies. Perhaps most important, they ensure continued stability in several important sectors in the event of a widespread financial crisis.

Benefits and Risks of the GSEs

Most risks facing financial institutions can be managed. Interest rate risk is minimized by matching the effective maturities of assets and liabilities. Credit risk is controlled through geographical diversification of assets, careful underwriting, avoidance of excessively volatile investments, and reinsurance. In most cases, risk exposure can be quantified. That is to say, probable losses (if any) can be computed for alternative hypothetical economic scenarios. Management's job is to assume only that level of risk that does not endanger the continued viability of the enterprise. A firm would typically consider recent economic events--high interest rates, recessions, oil embargoes, and the like--and build in sufficient protection against a recurrence of the most severe set of conditions. Of course, more protection against loss implies a reduction in the enterprise's mission, higher costs for its services, or both; such service cuts and cost increases often hit hardest at the most needy recipients. The task for the GSEs, and for those overseeing them, is to identify the benefits and risks and to determine the appropriate level of risk exposure.

It would be premature at this time to form a judgment as to the appropriateness of the GSEs' risk-return balance. The studies being conducted by the GAO and the Department of the Treasury, in conjunction with data and analyses from the enterprises themselves, will provide a basis for such conclusions.

While the GSEs should be resistant to normal business cycles and occasional financial shocks, we should not necessarily expect them to cope with a replay of the Great Depression. To do so might impose costs that would prevent the GSEs from performing their missions. Although unlikely to occur, one could develop a hypothetical scenario of negative economic growth, increasing unemployment, and declining asset values that would put pressure on one or more of the government sponsored enterprises. But in the event of a serious recession or the threat of depression, the government sponsored enterprises would probably be seen as a means of restoring stability and reviving economic activity in the sectors they are charged with serving.

In the event of a crisis, government policy would move to stabilize all important sectors of the economy, not only those where government sponsored enterprises exist. There is, in effect, an "implied guarantee" for the economy as a whole. In the past, the federal government has provided credit assistance to private corporations and municipalities to avert economic dislocation. In this context, the implicit guarantee of agency status does not constitute a large subsidy and differs only modestly from the implied guarantee against failure of any large private financial or nonfinancial institution.

Economic Effects of Government Credit Programs

Observers will disagree as to whether or not the government sponsored enterprises affect resource use, and if so whether that effect is beneficial or harmful. Some economists view these enterprises as simply another financial intermediary, a special-purpose bank, which functions alongside private institutions. Others contend that the GSEs' activities redirect resources toward housing, agriculture, student loans and the other designated sectors, either through removing capital market barriers or directly allocating resources.

In reality, each entity and each program is somewhat different. My former Brookings colleagues and I determined that the best way of identifying the effect of a particular program is to look at the subsidy element. Interest rate subsidies and underpriced credit guarantees are intended to reallocate income. Actuarially sound insurance programs and asset exchange (secondary marketing) activities tend to improve the functioning of private capital markets. Most of the subsidies in government programs will be found at the primary market level, while the government sponsored enterprises are largely engaged in improving the market for the resale of financial assets.

If government assists one class of borrowers to obtain credit that they would not otherwise receive, the cost of credit to other borrowers must rise to "crowd out" an equivalent amount of unassisted lending. But the mere presence of a government sponsored enterprise does not imply crowding out. First of all, many borrowers simply switch from the purely private intermediary to the GSE. Secondly, to the extent that government programs improve capital market efficiency, more resources are freed for productive uses and new lending. Although GSE debt may appear to dominate certain sectors, this may be a result of the efficiency of the GSE structure rather than a diversion of society's resources. In the absence of GSE activities, private sector participants would step in to provide similar functions although probably on a smaller and less efficient scale.

Investor Perceptions of Government Sponsored Enterprises

Investors in the fixed-income markets accord a special status to U.S. agency issues. This status arises from several sources. Most observers focus only on the widely held belief that the federal government would intervene to prevent bondholder losses in the case of a major economic collapse. Equally important, however, is the perception that federal government policy ensures the continued health of these enterprises through the oversight process. Another factor often overlooked is that GSEs are immune from leveraged buyouts and other forms of "event risk" that can quickly alter the credit rating of even a high quality private enterprise.

Investors are generally willing to accept a lower interest rate on agency debt than on purely private debt, all other things being equal. Under ordinary circumstances, however, the agency status is an incremental, not absolute, credit enhancement. The financial health of the entity, independent of government support, enters into the investor's decision. As evidence, one can compare the interest rates paid on a given entity's debt with some benchmark, such as U.S. Treasury securities of a comparable maturity. There exists a substantial variation in interest rates on similar debt across the GSEs, and a given entity will pay different rates at different points in time as its perceived financial condition varies. The existence of an implicit guarantee does not remove the incentive for these enterprises to operate in a safe and profitable manner.

The structure and governance of the GSEs provides additional market discipline, despite their preferred status in the credit markets. A broad range of views on the Boards of Directors of these enterprises is ensured by charter. Private market participants such as accounting firms, investment banks, and rating firms perform careful analyses of financial condition in connection with annual reports and securities issues. Neither members of the Board nor these other entities can rely on an implicit guarantee to relieve them of their professional and fiduciary responsibilities. Moreover, there exists substantial expertise within the federal government to conduct reviews of the GSEs' finances.

Conclusions

The government sponsored enterprises help recycle capital market resources, stabilize financial markets, correct market imperfections, and provide a source of innovation. Although the private sector has assumed some of the original activities of these enterprises, they still have a vital role to play in the financial system. Assessments of the risk exposure of the GSEs are appropriate, but should be conducted in the context of the entities' missions and the costs of marginal reductions in risk.

October 20, 1989

U.S. GOVERNMENT AGENCIES AND GOVERNMENT SPONSORED ENTERPRISES: LINKS TO FEDERAL GOVERNMENT AND LEGAL STATUS OF SECURITIES

LINKS TO FEDERAL GOVERNMENT	REFCORP	FICO	FARM CREDIT SYSTEM	FHLBS	FNMA	FHLMC	SLMA	TVA
Chartered by Act of Congress	YES	YES	YES	YES	YES	YES	YES	YES
Owned by U.S. Government	YES	NO	NO	NO	NO	NO	NO	YES
Directors Appointed by President and Confirmed by Senate	5 of 5	4 of 5	NO	YES	5 of 18	5 of 18	7 of 21	3 of 3
Ability to borrow from the U.S. Treasury ($millions)	NONE	NONE	NONE*	$4,000	$2,250	$2,250	$1,000	$150
Borrowing on Budget of U.S. Government	IN PART	NO	NO	NO	NO	NO	NO	YES
Backed by Full Faith and Credit of U.S. Government	NO	NO	NO	NO	NO	NO	NO	NO
Access to Borrowings from Federal Financing Bank	NO	NO	NO	NO	NO	NO	***	YES**
Principal Defeased by U.S. Treasury STRIPS	YES	YES	NO	NO	NO	NO	NO	NO
Interest Payments Guaranteed by U.S. Treasury	YES	NO	NO	NO	NO	NO	NO	NO
LEGAL STATUS OF SECURITIES								
Bonds Issued Under Authority of Act of Congress	YES	YES	YES	YES	YES	YES	YES	YES
Bonds Exempt from S.E.C. Registration	YES	YES	YES	YES	YES	YES	YES	YES
Legal Investment for National Banks	YES	YES	YES	YES	YES	YES	YES	YES
Bonds Issuable and Payable Through Federal Reserve	YES	YES	YES	YES	YES	YES	YES	YES
Eligible Collateral for Fed Discounts and Advances	YES	YES	YES	YES	YES	YES	YES	YES
Interest Exempt from State and Local Taxes	YES	YES	YES	YES	NO	NO	YES	YES
Eligible Collateral for Treasury Tax and Loan Accounts	YES	YES	YES	YES	YES	YES	YES	YES
Eligible for Open Market Purchases	YES	YES	YES	YES	YES	YES	YES	YES
Eligible for National Bank Repos Without Reserve Requirements	YES	YES	YES	YES	YES	YES	YES	YES
Bond Ratings from Moody's/Standard & Poor's	Aaa/NR	NR	Aaa/NR	Aaa/NR	Aaa/NR	Aaa/NR	Aaa/NR	Aaa/AAA

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* The Farm Credit System Assistance Corp. is authorized to borrow $4 billion (with principal and interest repayment guaranteed by the U.S. government) to recapitalize the Farm Credit System.

** FFB $2 billion line of credit in effect for two years until October 1991; to be considered for an extension in the future. FFB $2.5 billion borrowing facility for nuclear fuel lease financing available for next four years.

*** Not since 1982. $5 billion outstanding until 1996.

The CHAIRMAN. Thank you very much. I appreciate the time and effort that have gone into two such thoughtful statements. Let me address some questions to both of you here.

Mr. Carron, you stated that "the perception that federal government policy ensures the continued health of these enterprises through the oversight process" in effect helps explain these low yields that they are able to get on their debt issues. You also said, "There exists substantial expertise within the federal government to conduct reviews of GSE's finances," and yet Mr. Stanton says that HUD has no one assigned to examine or supervise the financial condition of Fannie Mae or Freddie Mac and Sallie Mae has no financial regulator at all.

Does that mean that the resources are there but not being used, and could this lead to the situation where investors could be misinformed?

I would like both of you to respond.

Mr. CARRON. I certainly believe that the resources do exist. I must say that I am not sufficiently familiar with, you know, how many individuals at HUD or some other agency may actually be employed on a day-to-day basis. But I was speaking only to the perception that investors have and my knowledge of the capabilities of the various agencies that do exist.

The CHAIRMAN. Would you be concerned if you found out that people were not examining it on a real-time basis carefully?

Mr. CARRON. I don't think that it is necessary to have people monitoring it full time. I think there are other protections for the investor. They are audited by outside accountants. When they come to the markets for equity or bond issues, there is a rigid process that they must go through which we call due diligence, whereby the private sector entities need to protect themselves against any lack of information or any omissions. There are the shareholders, the outside directors, all of which provide protections.

If it were in fact the case that no one at HUD was viewing these full time, that would not particularly concern me as long as the ability was there and I felt that some review were being made from time to time.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Mr. Chairman, there is a significant difference between the concern of an investor and the concern of the federal government. An investor doesn't lose any sleep if HUD is not watching a regulated institution because the government's implicit guarantee is still there.

The CHAIRMAN. Yes, the government is on the hook.

Mr. STANTON. That is right.

The CHAIRMAN. So the investor is going to get his money. It is just the government and the taxpayers that take it in the neck if the thing falls apart.

Mr. STANTON. Yes, sir, and in addition there is an incentive of some investors in return for higher profits to accept a higher level of risk than perhaps the government wants to take, and of course because of the implicit guarantee this raises the problem of moral hazard. If there is a big mistake, the taxpayers take most of the downside losses.

For example, I have here a publication of First Boston Corporation—I hasten to say that Andy Carron did not write this one—from April of 1989 talking about profitability of Fannie Mae and why it is a good buy, and it says, "The only negative trend—shrinkage in the on-balance sheet loan portfolio—appeared to begin to reverse itself in March," which means that investors benefit. If Fannie Mae is playing the yield curve and lending long and borrowing short, shareholders get higher returns for those risks, and they often find that attractive, not unattractive.

By contrast, the government might have quite a different stake.

Andy Carron is absolutely right that the key question for us is costs versus benefits. Freddie Mac does a good job serving the housing market with a negligible portfolio. What are the costs to the federal government in increased interest rate exposure versus the benefits to the housing sector of Fannie Mae's mortgage portfolio that is now over $100 billion? Do we get any significant benefits from Fannie Mae playing that yield curve, or do those benefits essentially go to the shareholders?

The CHAIRMAN. Well, and there is a question, too, as to what happens if they play the yield curve and they happen to do it the wrong way.

Mr. STANTON. That happened to Fannie Mae in 1979.

The CHAIRMAN. Yes. But yet they were able to sort of ride it out. But let me just ask you your sense for what the implications would be if they got into a yield curve mismatch and bad judgment that they couldn't ride out.

Mr. STANTON. Standard & Poor's this morning said they couldn't judge management quality unless they went in and examined the institution's management before making their rating. Andy Carron's point is that good managers are able to police credit risk, interest risk, and so forth.

The problem is that if management plays the yield curve and loses and the institution suddenly has negligible capitalization, it is a well-known precept in banking circles—and of course we saw it in thrift circles—that when you have got negligible capital in your institution then even the most prudent management has an incentive to go out and take risks. The banking regulators call this "betting the bank," heads, management wins and they keep their jobs, tails, they lose, but they would have lost their jobs anyway.

So that is the point one has to be most attentive, right when somebody has played the yield curve and if unfortunately they have lost.

Mr. CARRON. Mr. Chairman, might I just comment briefly?

The CHAIRMAN. Yes.

Mr. CARRON. Mr. Stanton is talking about Fannie Mae betting the yield curve, and so forth, and I assume he is speaking in a hypothetical manner because in point of fact what Fannie Mae has done since the early 1980s is to reduce and virtually eliminate its exposure to yield curve risk, and their additions to their portfolio have been substantially in the area of adjustable rate mortgages, which do not have the same sort of interest rate mismatch risk, and the stock market has rewarded Fannie Mae for this increase in portfolio matching, for moving to a safer, less risky status over that period of time.

Perhaps it would be useful if the entire First Boston research report that Mr. Stanton referred to were made part of the record. I think it would be helpful.

The **Chairman**. Sure, by all means, absolutely.

[Information furnished.]

Equity Research

First Boston

Industry: **Mortgage Finance**
April 13, 1989
SI1030

Eric I. Hemel **212/909-2524**

Fannie Mae FNM

Fannie Mae Reports First Quarter Earnings of $1.98; Investment Spread Up to 68 Basis Points in March; Foreclosure Losses at Two-Year Low; Portfolio Shrinkage Halts in March; Raising Our 1989 and 1990 Estimates to $8.60 and $10.00; Maintaining BUY Opinion

Price 4/12/89[1]	Earnings Per Share		Prev. Est.	P/E Ratios		Div'd Yield	52-Week Price Range
				Absol.	Rel.		
68½	1990E	$10.00	$9.60	6.9X	69%	$0.96	69-32⅞
	1989E	8.60	8.10	8.0	87	1.4%	
	1988A	6.32					

Common Shares	83.5 mil.	**Market Value**	$5.7 bil.
Book Value/Share (3/31)	$30.55	**Pretax Cash Flow/Share**	NM
Debt/Total Capital	NM	**Return on Average Equity**	28%
Next Quarter Est.	$2.15 vs. $1.52	**Est. 5-Year Growth Rate**	15%

[1] On 4/12/89 DJIA closed at 2319.6 and S&P Industrials at 345.0

Summary and Recommendation

In light of the company's stellar first quarter performance, we are maintaining our Buy recommendation on Fannie Mae. We are increasing our 1989 estimate from $8.10 to $8.60 and our 1990 estimate from $9.60 to $10.00.

Everything went right at Fannie Mae in the first quarter. The company ended March with a net interest spread of 68 basis points, up from 64 in February. The company lowered its loss provisions for the third consecutive quarter. The mortgage-backed security (MBS) juggernaut continued to roll, with MBSs outstanding growing at a 24% annualized rate during the quarter. The only negative trend—shrinkage in the on-balance sheet loan portfolio—appeared to begin to reverse itself in March.

We view our $8.60 estimate for 1989 as appropriately conservative. Our assumptions include: (1) no increase in the net interest spread beyond the 68-basis-point figure in March, with several basis points of shrinkage in the second quarter; and (2) no further reductions in loss provisions this year. A quarterly earnings model is presented in Table 1.

First Quarter Review

Fannie Mae reported first quarter earnings of $1.98 per share versus our expected $1.90. The following are first quarter highlights:

- A write-off of a data processing subsidiary reduced earnings by $0.07; adjusting for this nonrecurring charge, Fannie Mae's "normalized" earnings for the quarter were $2.05.
- The net rollover of high-cost debt coupled with an upward repricing of adjustable-rate mortgages moved the March investment spread to 68 basis

points. We believe that figure will shrink by several basis points in the coming months; debt rollover is more of a negative than a positive influence in the second quarter.

- Loan loss provisions declined to $80 million—the third consecutive quarterly decrease. This change, which we did not forecast would occur until mid-year, added $0.04 to quarterly earnings. Fannie Mae's decision to lower loss provisions was based on increasing evidence that the company's foreclosure losses are likely to decline at a steady pace over the next several years. Foreclosure losses of $58.1 million were the lowest since the first quarter of 1987.
- The company's on-balance sheet loan portfolio appears to have stabilized in March—after serious shrinkage in January and February. Spreads between fixed-rate mortgage yields and comparable maturity U.S. Treasury obligations have climbed rapidly over the last month; Fannie Mae officials have acknowledged that current spreads have crossed the threshold at which they would resume at least a moderate rate of on-balance sheet portfolio growth.

N.B.: The First Boston Corporation has, within the last three years, served as a manager or co-manager of a public offering of securities for Fannie Mae

Table 1
Quarterly Earnings Model

Table 1
Quarterly Earnings Model

	First Quarter 1988	Second Quarter 1988	Third Quarter 1988	Fourth Quarter 1988	Fiscal Year 1988	First Quarter 1989	Second Quarter 1989E	Third Quarter 1969E	Fourth Quarter 1989E	Fiscal Year 1989E	First Quarter 1990E	Second Quarter 1990E	Third Quarter 1990E	Fourth Quarter 1990E	Fiscal Year 1990E
Fully diluted earnings per share	$1.27	$1.52	$1.65	$1.88	$6.32	$1.98	$2.13	$2.20	$2.27	$8.59	$2.38	$2.46	$2.54	$2.61	$10.00
Fully diluted weighted average shares outstanding (mil.)	79.3	79.5	80.5	81.1	80.1	83.5	84.0	84.0	85.0	84.1	86.0	86.0	86.0	87.0	86.3
Forecasting Variables: (a)															
Asset growth	10.77%	21.55%	5[illegible]	-2.71%	8.51%	-2.01%	6.00%	6.00%	6.00%	3.94%	6.00%	6.00%	6.00%	6.00%	6.00%
MBS Growth	15.97%	38.06%	27.[illegible]	29.27%	27.36%	24.00%	24.00%	24.00%	24.00%	24.00%	20.00%	20.00%	20.00%	20.00%	20.00%
Average investment spread	0.45%	0.52%	0.52%	0.61%	0.53%	0.66%	0.66%	0.67%	0.68%	0.67%	0.67%	0.67%	0.66%	0.66%	0.66%
Administrative expenses	0.19%	0.20%	0.20%	0.21%	0.20%	0.20%	0.21%	0.22%	0.23%	0.22%	0.22%	0.22%	0.22%	0.22%	0.22%
Average MBS guaranty fee	0.209%	0.210%	0.208%	0.208%	0.209%	0.206%	0.208%	0.208%	0.208%	0.208%	0.208%	0.208%	0.208%	0.208%	0.208%
Effective tax rate	21.23%	23.41%	23.29%	25.29%	23.54%	25.59%	26.00%	27.00%	27.00%	26.43%	28.00%	28.00%	28.00%	28.00%	28.00%
Dividends per share	$0.12	$0.18	$0.18	$0.24	$0.72	$0.00	$0.24	$0.24	$0.24	$0.72	$0.24	$0.24	$0.24	$0.24	$0.96
Income Statement															
Net interest income	$170.80	$209.20	$217.20	$239.40	$836.6	$253.10	$257.76	$267.56	$276.14	$1,054.6	$281.6	$285.9	$290.5	$297.5	$1,155.4
Other income:															
MBS Guaranty fees	$74.6	$79.3	$84.4	$89.6	$327.9	$94.5	$100.5	$106.1	$111.9	$413.0	$117.6	$123.1	$128.8	$134.9	$504.4
Gains on sale	9.3	2.2	0.2	0.5	12.2	2.4	2.8	2.9	2.9	11.0	4.4	4.5	4.5	4.6	18.0
Other income	17.6	15.7	16.4	19.7	69.4	8.1	19.7	20.0	20.3	68.0	20.6	20.9	21.2	21.5	84.1
Total other income	$101.5	$97.2	$101.0	$109.8	$409.5	$105.0	$123.0	$128.9	$135.1	$492.0	$142.6	$148.4	$154.6	$160.9	$606.5
Other expenses:															
Provision for losses	$95.0	$95.0	$90.0	$85.0	$365.0	$80.0	$80.0	$80.0	$80.0	$320.0	75.0	75.0	75.0	75.0	$300.0
Administrative expenses	49.2	53.8	55.6	59.8	218.4	56.1	59.1	62.8	66.6	244.6	64.6	65.6	66.6	67.5	264.3
Total other expenses	$144.2	$148.8	$145.6	$144.8	$583.4	$136.1	$139.1	$142.8	$146.6	$564.6	$139.6	$140.6	$141.6	$142.5	$564.3
Income before taxes	128.1	157.6	172.6	204.4	662.7	222.0	241.7	253.7	264.6	982.0	284.5	293.7	303.5	315.9	1197.6
Effective tax rate	21.23%	23.41%	23.29%	25.29%	23.54%	25.59%	26.00%	27.00%	27.00%	26.43%	28.00%	28.00%	28.00%	28.00%	28.00%
Net income	$100.9	$120.7	$132.4	$152.7	$506.7	$165.2	$178.9	$185.2	$193.2	$722.4	$204.9	$211.5	$218.5	$227.5	$862.3
At Period-end:															
Total assets	$106,140	$111,447	$113,033	$112,258	$112,258	$111,689	$113,328	$114,991	$116,678	$116,678	$118,390	$120,128	$121,890	$123,679	$123,679
Total MBS outstanding	145,242	157,438	167,170	178,250	178,250	188,100	198,493	209,459	221,032	221,032	231,340	242,128	253,420	265,238	265,238
Total equity	1,898	2,005	2,125	2,260	2,260	2,419	2,578	2,743	2,916	2,916	3,100	3,291	3,488	3,695	3,695
Equity/assets	1.79%	1.80%	1.88%	2.01%	2.01%	2.17%	2.27%	2.39%	2.50%	2.50%	2.62%	2.74%	2.86%	2.99%	2.99%
Book value per share	$23.93	$25.22	$26.41	$27.87	$28.22	$28.97	$30.69	$32.65	$34.30	$34.30	$36.04	$38.26	$40.56	$42.47	$42.47
Return on average assets	0.39%	0.44%	0.47%	0.54%	0.46%	0.59%	0.64%	0.65%	0.67%	0.64%	0.70%	0.71%	0.72%	0.74%	0.72%
Return on average equity	21.77%	24.74%	25.65%	24.90%	25.14%	28.24%	28.64%	27.84%	27.31%	27.98%	27.25%	26.48%	25.78%	25.33%	26.16%

The CHAIRMAN. Let me go on here because our time is limited and there are some other items that I want to get to.

Because of the government's implicit guarantee these firms can issue debt at interest rates close to Treasury rates even if Standard & Poor's rates their debt, at least in the instance of one, as less than investment grade, or what we call the junk grade, if the guarantees were not present. He also—the Standard & Poor's fellow also indicated that some of the others are sort of just over the line into the investment grade category.

Mr. Carron, you say that no large subsidies are involved, but that looks—begins to look like a large implicit government subsidy to me. I am wondering if that is so, who benefits from that subsidy? How much of that subsidy goes to the borrowers and how much goes to the stockholders of the GSE?

Mr. CARRON. Let me answer two parts of that question, if I might.

Mr. Gillis was referring, or was performing his analysis on the assumption that one took away the implicit guarantee and left everything else in place exactly as it was. However, in the hypothetical event that the guarantee were taken away, I believe that at the same time some of the restrictions that are placed on these entities in terms of being confined to certain narrow lines of business that increase their risk might also be taken away, and at that point they could react and diversify the risk and perhaps would not be rated as low as Mr. Gillis suggested.

So I don't think that you can look at the guarantee in isolation. You also have to look at the charter restrictions, the public representation on the boards of directors, and the things that—the costs that go with the benefits of the agency status.

Now, in terms of who gets the advantage of the agency status, certainly in the mortgage area, in the housing area, which is the largest area of activity among the GSE's, mortgage rates are lower today than they would have been in the absence of the GSE's. Various estimates are that the benefit is as much as a quarter or half a percent on the homeowner's interest rate, and in fact when we look at interest rates on mortgages that qualify for GSE issuance versus those that don't, we do see differentials of this sort.

So certainly a substantial portion of the benefit is being passed through. If you multiply a quarter or a half a percent times the hundreds of billions of dollars that are outstanding, those benefits are flowing through.

Obviously, the success of these agencies has benefitted shareholders if one looks at the prices of the stock in the recent market, but I believe that by far the lion's share of the benefit has gone to the economy as a whole.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Mr. Chairman, I agree completely with Mr. Carron that GSE's can involve substantially increased risk because of their inability to diversify outside of their specified charter activities. I guess the key question is if a government-sponsored enterprise—take Fannie Mae and Freddie Mac, which we are talking about now—were required to maintain bank type capital requirements, how much of that subsidy for home ownership, the quarter to a half a percent, would be eaten away and how much would we be able still to benefit from?

Homeowners are also taxpayers. So homeowners have a benefit in trading off minimizing their risk as taxpayers to bail out a failed institution against the very positive benefits of lowering mortgage rates. So that I think is the essential cost/benefit question.

The CHAIRMAN. Now, let me ask you both, is there a way to reduce the taxpayer risk associated with GSE's while at the same time retaining most or all of the public benefits that are associated with them? Are there any adjustments here that we could make where we could get the best of both worlds?

Mr. Stanton, do you see any?

Mr. STANTON. Well, sir, the easiest of course is effective federal regulation. These are $290 billion, $260 billion institutions. The Federal Home Loan Banks are $175 billion financial institutions. These are huge institutions. It doesn't cost them much for all of their staff overhead and it wouldn't cost them that much more to begin to do what the major money center banks do, which is learn to live with a competent, capable regulator of safety and soundness. That would be, to my mind, a very cost effective beginning; in other words, take the regulation away from a HUD that apparently doesn't know how to exercise or doesn't have the mandate to exercise it, for sure doesn't have the resources, and conceivably centralize regulation of safety and soundness of all government-sponsored enterprises into a single agency like the FDIC or a single office like the Comptroller of the Currency.

The CHAIRMAN. Mr. Carron.

Mr. CARRON. Mr. Chairman, I think that competent and effective regulation is a key here. I would certainly agree with that. I think we ought to await the results of the Treasury and GAO studies to determine exactly where that regulation ought to exist. I think that the agencies themselves are performing many of the kinds of analyses that can tell us how much risk is there, under what circumstances might there be problems, and that this information could be communicated to a regulatory agency so the amount of risk can be quantified and the appropriate risk/benefit tradeoff can be made.

Mr. STANTON. Mr. Chairman, with respect to Government regulation I would respectfully submit that we already have a pretty clear idea of the answer. When something goes wrong with a specialized lender, be it a thrift, be it the Farm Credit System, be it Fannie Mae, it goes wrong in an awful hurry. The purpose of effective regulation is to prevent or try to prevent—it doesn't always work—something from going wrong, and given the negligible costs of that, I respectfully suggest the Federal Government should police the use of its guarantee and institute effective regulation now.

The CHAIRMAN. Mr. Carron, I don't know if this is the same investment advisory from First Boston. Is it dated April 14th?

Mr. STANTON. No, this is April 13th.

The CHAIRMAN. All right. In an investment advisory dated April 14th, 1989, First Boston said, and I quote, "The probability of

Fannie Mae facing higher capital standards compares with the likelihood that Congress will convert the Lincoln Memorial to a discotheque." [Laughter.]

[Information referred to follows:]

Equity Research

First Boston

Industry: Mortgage Finance
April 14, 1989
SI1064

Eric I. Hemel 212/909-2524

Fannie Mae FNM

Flurry of Recent Articles Takes Swipes at Fannie Mae; No Reason for Investor Concern; Maintain BUY Opinion

Price 4/14/89[1]	Earnings Per Share		Prev. Est.	P/E Ratios Absol.	P/E Ratios Rel.	Div'd Yield	52-Week Price Range
68⅛	1990E	$10.00	$10.00	6.8X	68%	$0.96	69-32⅞
	1989E	8.60	8.60	7.9	85	1.4%	
	1988A	6.32					

Common Shares	83.5 mil.	**Market Value**	$5.7 bil.
Book Value/Share (3/31)	$30.55	**Pretax Cash Flow/Share**	NM
Debt/Total Capital	NM	**Return on Average Equity**	28
Next Quarter Est.	$2.15 vs. $1.52	**Est. 5-Year Growth Rate**	15%

[1] On 4/14/89 DJIA closed at 2337.1 and S&P Industrials at 347.8

Articles Critical of Fannie Mae Are a Tempest in a Teapot

A flurry of articles has appeared in recent weeks in which critics took swipes at Fannie Mae because of the advantages it enjoys relative to other financial intermediaries—particularly thrifts. These articles have appeared in *The Wall Street Journal*, *The Economist*, and *The American Banker*. Their general themes have included:

- Fannie Mae (and Freddie Mac) have accelerated the thrift crisis by rendering obsolete the role that savings institutions play as mortgage market intermediaries.
- Fannie Mae's capital position is inadequate in comparison to the capital standards currently in force for commercial banks and prospectively for thrifts.
- Banks and thrifts pay insurance premiums for federal guarantees of their liabilities; in contrast, Fannie Mae enjoys federal agency status—and an implicit federal guaranty of its liabilities—free of charge.

For investors, the relevant question does not concern the analytical flaws or merits in these arguments. The relevant question is simply, will the federal government alter Fannie Mae's unique status at any time in the foreseeable future?

We conclude that neither Fannie Mae nor its investors has reason for serious concern. The probability of Fannie Mae facing higher capital requirements or any type of user fee compares with the likelihood that Congress will convert the Lincoln Memorial to a discoteque. We see no reason—based on political factors—to alter our BUY recommendation on Fannie Mae.

Fannie Mae FNM

Fannie Mae's Advantage: The Logic of Political Self-Interest

Our conviction that Fannie Mae enjoys a safe haven from regulatory interference with its operations and capital structure is based largely on several years of direct experience in the Washington political arena. During that period we had three observations which are still relevant:

- *The mathematics of political self-interest overwhelmingly favor maintaining the status quo.* Three key constituencies—mortgage bankers, realtors, and homebuilders—fiercely oppose any curtailment of Fannie Mae's role in increasing the flow of funds into housing. All three groups are well diversified geographically, resulting in the ability to place pressure on every member of Congress. Each group is also a powerhouse in the game of campaign contributions; the realtors and homebuilders are among the half-dozen or so largest contributors to political action committees. The one industry group which might partially favor limiting Fannie Mae's (and Freddie Mac's) role—the thrift industry—is divided internally on this subject. Besides, the thrifts are unlikely to spend scarce political chips on this matter when they will have bigger fish to fry on Capitol Hill for the foreseeable future.

- *Fannie Mae's leadership is extraordinarily skillful politically.* If legislators and their staffs were polled, Fannie Mae would probably rank as the nation's most capable corporation in its ability to use the Congressional process to defend its objectives. Management is intimately knowledgeable regarding the whys and wherefores of power politics. This is due in part to Fannie Mae's Washington location and also to its origins as a federal agency. Fannie Mae has never lost a major political battle in its 19 years as a public company. Current management deserves a great deal of credit for this success; but we believe that political prowess is so important to the company's well being that it is likely to be maintained regardless of future management changes.

- *Fannie Mae's interests generally coincide with those of homebuyers.* Fannie Mae and Freddie Mac have enhanced the efficiency of the secondary mortgage market, thereby reducing mortgage rates—albeit moderately. The political resonance of its pro-housing function has played a major role in the company's legislative success.

Fannie Mae's Capital Requirements: No Impediments to Its Franchise

Fannie Mae's capital requirements are established by the Department of Housing and Urban Development (HUD). HUD currently imposes a 20:1 minimum debt-to-capital requirement on Fannie Mae. By HUD's calculations, Fannie Mae's current ratio is 18:1. Under existing statute, HUD could at its own discretion reduce the minimum ratio to 15:1.

Contrary to appearances, however, Fannie Mae has little reason to view capital requirements as a prospective constraint on its future operations. What makes HUD's requirement a red herring is that Fannie Mae is allowed by statute to include subordinated debt in its computation of regulatory capital. While the company's debt-to-equity ratio on a GAAP basis is 45:1, on a regulatory basis, including subordinated debt, it is currently 18:1. Thus, Fannie Mae can always improve its regulatory capital ratio further by raising additional subordinated debt. Fannie Mae pays only 10 to 15 basis points more for subordinated debt than for other debt instruments; the public markets perceive Fannie Mae's subordinated debt as implicitly backed by the federal government, which would almost certainly prove correct if Fannie Mae ran into trouble. The ability to maintain a highly leveraged balance sheet in the absence of regulatory interference provides an important ingredient in Fannie Mae's remarkable franchise.

N.B.: The First Boston Corporation has, within the last three years, served as a manager or co-manager of a public offering of securities for Freddie Mac.

I am wondering if that view might be based on a judgment by First Boston that an increase in capital would be unwarranted or rather that Congress would be indifferent to the question or not think that it was needed.

Can you shed any light on that?

Mr. CARRON. Well, Mr. Chairman, not being familiar with the study that you are referring to, I can only speculate. I think that the answer is probably partly that a substantial increase in capital was viewed by the analyst as not being necessary and, secondly, that the public services being provided by Fannie Mae would be deemed sufficiently important so that they would not be required to impair them by imposing higher capital.

The CHAIRMAN. Well, just one person's opinion; namely, my own, I agree the point that I think both of you have made, that the studies that are now underway that were referred to earlier with the Treasury Department are very important pieces of work. That is why we put them in the legislation, and so they are a matter of law that they are being done, and we will have the results of that in the early spring and we will use that as the basis for whatever judgments and actions we may feel are necessary at that time.

But I want to make it clear, just speaking for myself, that if those studies were to convince me that additional capital were needed in any or all of them, I would undertake an action to put it in place.

So I don't want any investment writer anywhere to misunderstand the implications of the importance of the capital standards issue. We have just taken a huge hit with respect to the 30-year, $275 billion cost of the savings and loan collapse, and most of these things were in place even beyond what we have talked about here—elaborate regulatory scheme, state regulatory scheme, outside accounting standards, the need to make financial disclosures on a regular basis, securities requirements with respect to stock offerings, things of that kind—and yet despite all of that the system capsized and the costs have been absolutely horrendous. I think the notion that we are immune from that in other areas, no matter how much more wisely managed and structured and with different risk profiles, can leave us in a potential position of major calamity. I am not predicting one here, but I think our obligation goes further than we have taken it. I think in light of our experience and in light of the fact that we have taken ourselves out pretty much to the far edge of our financial capacity in the country, that that imposes a new burden on all of us in looking at these questions.

We are in a situation right now where we have had the hurricane on the Southeast coast, we have had the earthquake on the West Coast, we have got the extraordinary financial needs in Poland and other places, and we are finding, frankly, that we don't really have the money available to respond to these issues as we need to. I mean, we are finding there is a real pinch, and there is a pinch because of a whole train of decisions over many, many years that have left us in a situation where our financial capacity has been strained right to the very outer limits. I find that a cause of great concern, and I think it can be measured in many different ways but when you start to apply concerns that come off that to any huge outstanding credit balance that the federal government is on the hook for and the taxpayer is on the hook for, I think it now imposes on us a new level of analysis. We must accept a new level of fiduciary responsibility beyond what we may have thought necessary in the past, and it will be something that this committee will be keenly interested in. That is exactly why we are doing the hearings today, so that we are in a position to examine and understand exactly what may be building up out there in the way of new risk profiles, not just the first level risk profiles but maybe second or third level, aggregate risk profiles.

So we have been looking at the condition of the banking system to see exactly how that looks. We have had a series of hearings on that. We will be undertaking a series of legislative initiatives with respect to correcting some of the deficiencies that obviously were present in the HUD area, and more will be done on that in short order. But we are going to examine this very carefully, as we will any other area of major systemic economic and financial risk that overhangs the country and the system.

The Defense Production Act is in a different category, but it relates very importantly to our strategic capacity as we see certain erosion in key trend lines that impact on that. We have had hearings in that area.

So this is a separate categorical look at major outstanding debt areas of the federal government at the present time. We are not in a position to make final judgments about it now but let there be no mistake about the fact that we are bringing it up on the radar screen for a very careful look that will go on over a series of months to decide what steps may be needed. Whatever comes out of that work that may require changes, I will initiate—with the support, I hope, of my colleagues on both sides of the aisle—changes that may be called for.

Senator Wirth, I am finished with my questions and I am wondering if you have any comments or questions.

Senator WIRTH. Very briefly, Mr. Chairman, thank you. I am sorry I wasn't here earlier. We have been looking at Rocky Flats and the nuclear production capabilities around the country, a topic even more problematic than the of S&L issues and GSE's.

I share your concern about the financial state of where we are and the debt question and our ability to operate at all. I was astonished this morning to see on the front page of both newspapers news of the sale of Rockefeller Center to Japanese interests. I suppose that there is no place in the country, I think, that perhaps is more a symbol of capitalism than Rockefeller Center and the Rockefeller family and everything that New York is all about, and here we are selling it to the Japanese.

That is not a commentary on the validity or nonvalidity of sale of goods to the Japanese or sale of property in Hawaii or banks around the world. It is just a commentary on the fact that we are running this enormous deficit and we are overspending like crazy, borrowing money, and that money has to go somewhere. It is coming right back in, and here is, the purchase of this symbol of capitalism, and we have an Administration that continues to do nothing about the deficit. I mean nothing about the deficit.

I echo your concerns as previously expressed.

A couple of questions and quick comments for our two witnesses.

The CHAIRMAN. Senator Wirth, before you do, if I can just add a comment to yours, and I share your concern about that and some of those topics came up in passing earlier today—this proposed announcement of the sale of 51 percent of the Rockefeller Center assets, the Columbia Pictures situation and even the fact that the services of ex-President Reagan are for hire—all of these I think are symptomatic of this deterioration in our international financial position, and it is a very severe problem. We seem to have a very hard time figuring it out as a nation because it is complex and it is a very hard truth to face, but our international debtor nation status is such that we are adding international debt at the rate of a billion dollars every three days in addition to what is already outstanding. We are at about $650 billion in that debtor nation hole now, lead all the other nations, and on our way to a trillion dollar total in 1992. So says Gerald Corrigan of the New York Fed.

Our debtor nation position is taking the form of international purchasers coming in and picking off key assets—not just real estate assets that are high visibility or movie companies, but high technology firms, forests, other strategic items for our future. Unfortunately, ownership with these kinds of trends running matter greatly to our future because the new owners, not only will be determining what the rents are, the wages that are paid in the facilities that they own here, whether they be buildings or manufacturing facilities, but the earnings will be rebated to them and to their society and to their children and to their grandchildren and otherwise that would have been the part of the legacy to our children and our grandchildren. These are extremely disturbing set of trend lines and it is no time for "Don't worry, be happy."

I think it is time to take a very serious reading on this deterioration in our relative international financial position and lay out a national strategy for turning it around that involves real effort and sacrifice and surge on the part of all Americans and to get on with the job of implementing that strategy.

I am just motivated by your comments to add my own, and I appreciate your yielding for that.

Senator WIRTH. I just hope we have other people join in the cry that this Administration stop presiding and start governing. To me, that is a very real distinction that has to be made, and, you know, there is only one Administration and one leader, and that comes out of the White House.

I am very pleased you are having this hearing, Mr. Chairman, and I find myself looking, going to the specifics at all of the GSE's, while most of these are not technically guaranteed by the government, de facto they are. So therefore if something were to start to happen to any of these, clearly the government would come and step in.

Now, how far do we want to go I think is the question that we face. It is very late in the—you all have been here for a long time, and I am late, but I am very interested in this question—Mr. Corrigan again at the New York Fed raised it—that we ought to be taking a very careful look at how risk free we are attempting to make this marketplace. I think we have gone much too far, both in deposit insurance and in a variety of other areas, and I think we have to come to understand that and look very carefully at it.

Senator Graham of Florida and I had introduced legislation reflecting the concerns of the New York Fed a couple of years ago and are looking at that again, and one of the three major themes that he raised was the risk-free nature, how far government insurance goes, and effectively, in looking at GSEs, we are talking about another leg of de facto—I think de facto government insurance, and what are the implications of that for the overall strength of our economy, the role of the Federal Government in the economy. Some very, very interesting questions.

I had a number of specific ones which I will include in the record. I just want to thank you for doing this. I think this is an important inquiry. I don't think it has been done elsewhere. I know that some of this is required in the S&L bailout legislation, and we are on our way to looking at it. There are some awkward questions. There will be some interests out there that don't want these questions asked, I am sure. They have got a pretty nice deal under the umbrella of the Federal Government, but I think we have an obligation to look at this as we should have been more aggressively looking at some of the other aspects of where the Federal Government is involved.

So I want to commend you and the committee for undertaking this hearing and this examination. Mr. Stanton and Mr. Carron, thank you both for being here. I don't have any specific items for you, but I really appreciate your attention and concern.

The CHAIRMAN. Let me just say one other thing related to that. We have two important hearings coming up that get at these issues, and there are a number of people in the room today that ought to be apprised of it.

On the 14th of November, which is essentially 2 weeks from now, we are going to have a panel in here talking about our overall economic position as a nation and the trend lines that we are riding in this global economy. We will have Professor Friedman from Harvard, we will have Mr. Dan Burstein, and we will have Larry Schimmerin. I think these three people are probably as capable, individually and as a group, of really putting into clear focus where we are and where we are going as a national economy as any three speakers we might have, and I recommend that to all of you here present within the sound of my voice.

The next day after that, on November 15th, we will be having three Nobel Prize economists coming in, also, to address that question of our economic future. We will have Mr. Samuelson, Mr. Kline, and Mr. Modigliani—I should probably say doctors in each case—with us to also try to help us frame in this larger economic picture in context, in which all of these sub-elements are key components, including the GSE's that we have focused on today.

So let me again thank these two witnesses for very well-prepared statements and for their responses.

The committee stands in recess.

[Whereupon, at 11:48 a.m., the committee was adjourned.]

[Response to written questions follow:]

Questions for Andrew S. Carron from Senator Donald W. Riegle, Jr. October 31, 1989

Q.1. You argue that GSEs may be more efficient than alternative private sector providers of the same or similar services. What accounts for that extra efficiency? Is the fact that they are able to operate with less capital part of the explanation? Better management? Massive scale? Or something else?

Q1. The extra efficiency is due to superior information, economies of scale, and lower administrative expenses.

Q.2. What is the effect of GSEs on the health of competing financial intermediaries? Do our implicit guarantees of GSEs substantially raise our risks of loss on deposit guarantees?

Q2. More efficient producers will always drive out the less efficient. The only alternative is to ask homebuyers to subsidize inefficiency.

Q.3. Should we require SEC registration of all GSE issues?

Q3. The rules under which GSEs operate require them to provide information to investors comparable to that required for SEC registration. Therefore SEC registration would not appear to provide additional investor protection.

Q.4. Do we need minimum real capital standards for all GSEs? If not why not?

Q4. GSEs, like other regulated financial institutions, should have minimum capital requirements. Ideally, the capital should be measured on a "real" or "current value" basis, although this presents certain methodological difficulties. The required level of capital should be determined separately for each GSE and should be consistent with the riskiness of its overall portfolio.

QUESTIONS FROM SENATOR RIEGLE REGARDING
UNDER SECRETARY GLAUBER'S TESTIMONY OF OCTOBER 31, 1989

Question

In your view, what kinds of public purpose activities are best carried out through use of GSEs rather than through direct government programs or through regulations or incentives affecting more purely private organizations?

Answer

Federal credit assistance programs are designed to meet various social or economic goals that the private sector does not meet on its own. Meeting these goals may involve the provision of subsidies to favored borrowers or the correction of perceived capital market imperfections to increase the amount of credit available for specific purposes. From a management perspective, it is with respect to the first objective (provision of subsidies) that the need for direct Federal intervention and control is greatest. Thus, the subsidy objective has generally been addressed by programs of direct Federal loans and Federal loan guarantees. GSEs have traditionally been created to improve the private market mechanism.

Question

Legal language regarding these agencies' access to Treasury loans varies from GSE to GSE. Should they all be the same? Where you have discretion, have you thought about what circumstances, if any, might prompt you not to make loans to GSEs when requested?

Answer

We can see no reason to conform the provisions of the charter acts of the GSEs that have authority to borrow from the Treasury to standard legislative language. The purpose of the borrowing authority is to be a backstop for the GSEs' obligations. It is not appropriate for the GSEs to use this borrowing authority as a matter of convenience. None of them does, and the Treasury does not now hold obligations issued by any of the GSEs.

Question

For each of the past 5 fiscal years, what are the ratios of government borrowing -- counting Treasury issues, explicitly guaranteed borrowing, and issues of GSEs -- to the private domestic savings pool and to the total private saving pool including foreign investment in the United States.

Answer

The ratios of government borrowing -- counting Treasury issues, explicitly guaranteed borrowing, and issues of GSEs -- to the private domestic savings pool for FY 1984 through FY 1988 (latest available data) are 36.6%, 41.6%, 56.5%, 49.3%, and 40.1%, respectively.

The ratios of government borrowing -- counting Treasury issues, explicitly guaranteed borrowing, and issues of GSEs -- to the private domestic savings pool, including net foreign investment, for FY 1984 through FY 1988 (latest available data) are 32.2%, 35.5%, 46.9%, 40.2%, and 34.6%, respectively.

Questions for Thomas Gillis from Senator Donald W. Riegle, Jr., October 31, 1989

Q.1. You described two GSEs as being at the high end of investment grade, but without an implicit government guarantee, the others were lower. What would the others have to do to become AAA quality? How much capital would they need if they made no other changes? What other changes would help keep capital needs down?

A.1. What would Fannie Mae, Freddie Mac, and Farm Credit System have to do to become AAA quality?
How much capital would they need if they made no other changes?
What other changes would keep capital needs down?

In assessing the risk to the government of the federal agencies, we review the same factors we do for private sector companies. These include industry risk, competitive position, business and financial strategies, risk management, asset management and financial performance. Financial performance includes a review of earnings quality and profitability, asset quality, asset liability management, liquidity and capitalization. The disclosures routinely made to S&P by rated private sector companies exceeds the disclosure by the government sponsored enterprises. Consequently, the opinions expressed in these responses reflect the public disclosure made by the GSE's and relevant industry and analytical comparisons. FNMA, FHLMC, and Farm Credit would have to make changes in their business operations and financial policies, reducing the risk of their organizations as well as improving their current financial condition primarily with additional capital.

FNMA & FHLMC

These agencies operate in a fashion which tends to maximize market share and rely on high amounts of leverage (the relationship of current and contingent liabilities to equity). Changes in these policies, both operating and financial, would be necessary to obtain a "AAA" rating. Operating policies would include slower growth and better underwriting. While FHLMC and FNMA have conservative published guidelines, a number of transactions do occur on a negotiated basis.

Financial policies should include a rapid build up of equity and reserves, relative to on and off balance sheet risks. Interest rate risk at FNMA and should be substantially reduced. This can be accomplished either through portfolio run off or use of their REMIC authority to perfectly match assets and liabilities.

Precise capital levels are difficult to determine, without having detailed information on the loans they have in their portfolio or under their MBS program; only estimates can be made. Information such as underwriting guidelines, loan to value, repayment terms, property types, geographic diversification and seasoning are necessary in assessing capital. Lastly, capitalization is just one of many financial components that make up a rating.

Farm Credit System:

A level of capital appropriate for the Farm Credit System at 'AAA' would be equally as difficult. Because of the lack of diversification and the relatively high level of risk for agricultural loans, capitalization would be at such a high level it would probably not be economically feasible for an organization to achieve a 'AAA' level.

Q.2. Mr. Carron made the point that your evaluation of the senior debt of these institutions might be lower than that of asset-backed securities issued by GSEs. Can you estimate what the investment quality of those securities would be without an implicit government guarantee?

A.2. Would senior debt be rated lower than asset-backed debt?

While some asset backed debt could be rated higher than senior debt, we do not feel that is the case with mortgage backed securities issued by Fannie Mae and Freddie Mac. As stated on the cover of the prospectus, these securities are guaranteed by the respective corporations. Any shortfalls in the cash flow would be made up by the corporation. In a bankruptcy and liquidation of a corporation issuing these types of securities, the liquidation value of any asset pledged to security holders may be higher than the liquidation value to senior debt holders because of the mortgages. This alone however is not enough to provide a higher rating for the asset backed securities than the senior debt.

Q.3. Is there anything that you have not found in the way of information that perhaps should be available, that would help not just you as an outside rating service but anyone else to assess the strength and credit worthiness of one of these organizations?

A.3. Is there any information that perhaps should be available that would help evaluate the creditworthiness of these organizations?

All of the GSE's which we evaluate provide to the public similar information as do private companies. We regard the public disclosure as adequate and largely consistent with the disclosure of financial service forms. However, it is noteworthy that banking, thrift, securities and insurance industry participants must comply with a level of regulatory requirements which provide meaningful information with regard to risk adjusted capital adequacy measures, lower of cost or market and mark to market accounting disciplines, portfolio concentrations, and counterparty exposures.

Questions for Thomas Gillis from Senator Jim Sasser, October 31, 1989

Q.1. Both Fannie Mae and Freddie Mac have grown tremendously in recent years. Based on data from its 1988 annual report, Fannie Mae's assets have grown from $88 billion to $112 billion since 1984. More dramatically, Fannie Mae's outstanding mortgage-backed securities commitments have grown almost 400% from $36 billion to $178 billion. In Freddie Mac's 1988 annual report, one can see that its assets have grown 149% and its guaranteed sold portfolio has grown 223% from $70 billion to $226 billion.

In fact, these two organizations in many ways have come to dominate mortgage markets. According to a study by Michael Lea, in 1986 these agencies securitized 60% of new originations. Further, few private firms compete against these two in issuing mortgage backed securities in the conforming market.

Is there a danger that these two organizations are benefitting from their government sponsorship at the expense of possible competition in mortgage financing markets? Do Fannie and Freddie currently have oligopoly powers in the market place? If so, what impact would these oligopoly powers have on the costs of mortgages to homeowners in the absence of broad-based, cost-cutting competition?

A.1. Fannie Mae and Freddie Mac dominate the issuance of mortgage backed securities. In a report released by the GAO in September 1988, the share of pass through mortgage backed securities was reported to be:

Ginnie Mae	39.7%
Freddie Mac	30.3%
Fannie Mae	25.5%
Private MBS	4.5%

There can be little doubt that the GSE's benefit from their "agency status", which assures them a plentiful supply of attractively priced funds and a market tolerance for relatively higher financial leverage. This advantage makes it extremely difficult for private entities to compete. In effect, this keeps guarantee fees low and arguably benefits the mortgage borrower.

Q.2. I believe strongly, and I think my colleagues would agree, that studies of the GSEs cannot be carried out in a vacuum. They must take into account the individual GSEs' special public missions. And, in making any recommendation, you must factor in the impact of any such changes on their ability to continue to carry out their public missions.

I would like to know what consideration you are giving to the public missions the individual GSEs have been established to serve?

Is the cost of the mission worth the benefit?

A.2. When approaching analysis of the securities of the GSE's with regard to the risk to the investor, public purpose is given some weight. Congress defined the public mission was to be served by creating these GSE's and demonstrates continuing belief and support of the mission thought the enabling legislation for the GSE's. However, the public mission is only one of many links to the U.S. government which Standard & Poor's reviews when considering the risk to the investor.

On the other hand, when analyzing the risk to the government, Standard & Poor's looks more at the business that is being carried out by the GSE. The public mission is not considered specifically in this analysis. Authorizing legislation can have an impact on the risk however. For example, the GSE's can only operate in the areas authorized by Congress. They cannot diversify business lines to balance the risk of one type of service. The Farm Credit System, while somewhat similar to a private sector lending institution, can only offer loans in the areas which are authorized by Congress.

Q.3. In looking at the potential risk posed by the GSEs, it's interesting to note that a private commercial bank like Morgan Bank has a triple A credit rating and is required by law to have at least 6% tangible capital. Moreover, every single day there are armies of examiners from the bank regulatory agencies inside Morgan assessing the risk posed to the insurance fund.

In contrast, Standard and Poors said a GSE like Fannie Mae would have a triple B credit rating if it was not government guaranteed -- a junk bond rating. It's capital is .8% of its assets. And there are never any federal regulators inside Fannie Mae. But Fannie Mae is four times the size of J.P. Morgan.

Are we comparing apples and oranges? Or is there significant risk posed by the GSEs?

A.3. J.P. Morgan is the only U.S. bank with Standard & Poor's highest rating 'AAA'. While all U.S. banks come under the same regulators there is a considerable difference in credit risk and therefore ratings on the securities. S&P's commercial bank ratings currently range from a high of 'AAA' to a non-investment grade rating of 'B'.

Federal bank supervisory agencies exert considerable influence on banks' financial reporting practices, principally through instructions issued by the Federal Financial Institutions Examination Council on the filing of quarterly call reports. Such regulatory scrutiny is helpful in identifying and controlling risks, thus benefiting credit quality.

But the analysis of the creditworthiness of a commercial bank involves many more factors. S&P has developed a number of benchmark ratios for banks and bank holding companies in four key areas of analysis: profitability, asset quality, capital and liquidity. A number of variables, such as market penetration, geographical location, business mix and management need to be blended with the financial ratios to provide a clear picture of financial risk.

We have provided this brief discussion of our approach to credit risk for banks to illustrate that the regulators, while important, are but one aspect of credit evaluation.

We feel this would be true in evaluating credit risk for a company like Fannie Mae. Even if Fannie Mae had regulatory input similar to commercial banks it would be just and additional factor.

Thus, having a regulator does not provide a guarantee of credit protection. The 'AAA' rated J.P. Morgan is regulated, but so was the very troubled savings and loan industry.

Q.4. The recently enacted thrift bailout legislation -- FIRREA -- imposes a fairly hefty burden on the Federal Home Loan Banks. For the next three years they are required to contribute a significant share of their retained earnings for the purchase of the REFCORP zero coupon bonds. Moreover, they'll be required to contribute a portion of their earnings to the new affordable housing program. I happen to think this program is meritorious, but I wonder what do you think is the long run financial condition of the Federal Home Loan Banks? Will permitting credit unions and commercial banks to borrow from their window significantly help them?

A.4. Standard & Poor's believes that the credit quality of Federal Home Loan Banks will not be negatively impacted because of the FIRREA. For Letter of Credit purposes, we maintain 'AAA' ratings on the individual banks which have been assigned. However, the trend evidence by FIRREA in utilizing and thereby depleting the capital resources of the FHLB's to fund the cost of the thrift bailout is negative for the creditworthiness of the banks. There is increasing evidence that the cost of the bailout may well exceed estimates at the time of the 1989 legislation. Any future depletion of the FHLBank's capital would increase the risk to the government.

It is too early to tell whether permitting credit unions and commercial banks to join the FHLBanks will help them financially. Given the requirements for membership and the prospect for lower dividends, many commercial banks and credit unions may not find it attractive to join.

The amounts required from the Federal Home Loan Banks to support the Affordable Housing Program, while not immaterial, are not of sufficient magnitude to affect adversely the credit quality of the banks. At the fully phased in contribution of the greater of 10% of net earnings or $100 million a year after 1994, the banks should still be able to report profitability and capital ratios sufficient to maintain 'AAA' evaluations without regard to federal support if all else is the same.

Q.5. The stock for the Federal National Mortgage Corporation has done very well this year. Institutional investors like fidelity's huge Magellan Fund have purchased large quantities of Fannie Mae stock, evidently impressed by the current profitability of this stock and its future profit potential. Certainly, as some of the testimony presented today shows, these government sponsored enterprises benefit from their real and perceived ties to the Treasury. I am, therefore, troubled by the prospect that there may be a tension between the need of these government sponsored enterprises to maximize the returns to their shareholders, and the public purposed for which there enterprises were chartered. For example, could the profits generated by these enterprises be lessened in order to reduce the cost of mortgages to the homebuying public? Do you believe there is a tension between the private ownership and the public missions of certain GSEs?

A.5. If a company counts on a large number of private shareholders, it would be hard to reduce profits to lower costs to homeowners significantly. Shareholders look for the company to provide competitive returns relative to the risks of ownership. If earnings or profitability decline, the perceived value and share price can decline, making it more difficult and costly for the company to raise capital.

Following this line, if the public mission, however it is defined, can be profitable, there would be less tension. If the public mission does not enable the company to make a profit, there would be a greater tension.

Q.6. Leland Brendsel, the President of the Federal Home Mortgage Corporation, Freddie Mac, has said that his organization has modeled Freddie Mac under numerous adverse economic scenarios. According to Brendsel, Freddie Mac would remain viable under the most severe of circumstance -- 10 years of high interest rates. To what extent do you agree with Mr. Brendsel's assessment of his organization, and to what extent are other government sponsored enterprises protected from adverse economic circumstance like high interest rates, severe inflation, or a prolonged recession? Could Fannie Mae withstand a stress test of the severity of the one under which Freddie Mac was tested?

A.6. We have listed below some of the issues which would affect Freddie Mac in a high interest rate environment. A high interest rate environment would not in always have an adverse affect on Freddie Mac as you will see in scenarios described below.

* approximately 95% of Freddie Mac's mortgages are funded by issuing pass through securities, thereby minimizing interest rate risk to Freddie Mac. Thus the GSE has locked in the guarantor fee (insurance premium) as opposed to an interest income, interest expense position.

* Higher interest rates will reduce refinancings and prepayments thereby increasing the value of the guarantee fee annuity. Likewise, float reinvestment returns will improve as average life extends and investment rates are higher.

* If higher interest rates are driven by inflation and price increases carry over into the housing sector, foreclosure losses should decline as property values increase.

* On the other hand, higher interest rates should result in higher credit losses especially for adjustable rate mortgages.

* Higher rates would adversely affect Freddie Mac's small investment portfolio to the extent investments are not match funded.

* If Freddie Mac holds a mortgage loans pending sale and does not hedge the position, the value could fall. (Bob to rewrite something here) if rates did fall Freddie Mac adjusts its hedging strategy as its assessment of overall interest rate conditions change.

* Because $18 billion of Freddie Mac's $20.1 billion in debt is short term,

debt service obligations will increase in higher interest rate environments. However, interest income from mortgage loans held pending securitization should rise assuming a normally sloped yield curve and subject to the percentage of adjustable rate mortgages held for resale.

During the early 1980's Freddie Mac was consistently profitable while Fannie Mae showed losses. The size of Freddie Mac's retained portfolio was small relative to its guaranteed PC's. The stable fee income generated from the PC's was more than sufficient to absorb any negative carry on the retained portfolio that resulted from higher interest rates. Fannie Mae's losses were caused mainly by the negative carrying costs on the portfolio. These negative carrying costs resulted from the higher funding expenses incurred during 1980 and 1981.

Q.7. Researchers with the Harvard Institute for Economic Research recently concluded that the maturing of the baby bust generation into their homeowning years will have a significant impact on the demand for housing. According to researchers Mankiew and Weil, real housing prices are projected to decline by 47% over the next 20 years. Now, in an economic environment where housing prices are not keeping up with inflation, you are likely to see a disinvestment in housing, and perhaps, significant increases in defaults. If it is true that real housing prices will decline, what impact would this have on the government sponsored enterprises that have a heavy involvement in housing markets?

A.7. Real housing price declines will impact FNMA and FHLMC. The extent to which it will is difficult to predict. The two causes that significantly impact default are unemployment and falling property values on a nominal basis. Real price declines suggest that nominal prices will not decline. Therefore, significant levels of default should not occur. However, real price declines indicate an absence of inflationary pressures on home prices. The current underwriting practices in the market rely on inflation in the underwriting process. The absence of inflation should cause an overall rise in delinquencies and foreclosures. These increases will reduce the profitability of FNMA and FHLMC, and thereby inhibit capital formation at the entities.

QUESTIONS FROM SENATOR SASSER REGARDING
UNDER SECRETARY GLAUBER'S TESTIMONY OF OCTOBER 31, 1989

Question

Is there a danger that Fannie Mae and Freddie Mac are benefitting from their government sponsorship at the expense of possible competition in mortgage financing markets. Do Fannie and Freddie have oligopoly powers in the marketplace? If so, what impact would these oligopoly powers have on the costs of mortgages to homeowners in the absence of broad-based, cost-cutting competition?

Answer

Fannie Mae and Freddie Mac were established to raise funds in the credit markets to augment the flow of funds into home mortgages. Their special relationships with the government lessen their costs of financing, compared with that of purely private entities, and give them competitive advantages.

Data compiled by the Department of Housing and Urban Development indicate that most financing for residential mortgages is provided by sources other than Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac combined hold (or have converted into mortgage-backed securities) approximately 21 percent of outstanding mortgages on 1-4 family properties and approximately 6 percent of mortgages on multi-family properties. The remainder have been converted into GNMA or conventional mortgage pools by mortgage originators or other facilities, or are in the form of whole loans held by the originators or institutional investors.

Question

I believe strongly, and I think my colleagues would agree, that studies of the GSEs cannot be carried out in a vacuum. They must take into account the individual GSEs' special public missions. And, in making any recommendation, you must factor in the impact of any such changes on their ability to continue to carry out their public missions.

I would like to know what consideration you are giving to the public missions the individual GSEs have been established to serve?

Is the cost of the mission worth the benefit?

Answer

Our two studies of GSE activities will, where possible, quantify the risks associated with each of the eight GSESs to be studied. In quantifying which risks, we will, as required under FIRREA, determine the volume and type of securities outstanding which are issued or guaranteed by each GSE, the capitalization of each GSE, and the degree of risk involved in the operation of each GSE due to such factors as credit risk, management and operations risk, and business risk. In assessing the risks posed by the GSEs, we will take into consideration the special public missions of the GSEs and the unique environments in which they operate.

The primary focus of our studies will be on the risks associated with GSE activities and the impact of GSE borrowing in the market on Federal and federally-assisted borrowing. We will not address in these studies the question of whether the cost of the public mission of each GSE is worth the benefit which it provides.

Question

Should the GSEs be subjected to a level of regulation and examination similar to that of a private commercial bank like Morgan Guaranty? Are commercial banks and GSEs directly comparable, or are we comparing apples and oranges? Is there significant risk posed by the GSEs?

Answer

GSEs are not directly comparable with commercial banks for several reasons. Unlike commercial banks, a large part of GSE operations are confined to the secondary markets for mortgage, student, college, and agricultural loans. Moreover, GSEs do not take insured deposits, but rather finance the bulk of their activities in the securities markets. Because of their different roles as primary and secondary lenders, the risks faced by GSEs and commercial banks are in many cases different.

The extent of Federal risk exposure as a result of GSE operations is a subject of the Treasury study. In addition to the risks faced by GSEs, the study will focus on the methods GSEs use to control risks, the capital on hand to withstand adverse events, and the extent and role of Federal oversight and supervision.

Question

The recently enacted thrift bailout legislation -- FIRREA -- imposes a fairly hefty burden on the Federal Home Loan Banks. For the next three years they are required to contribute a significant share of their retained earnings for the purchase of REFCORP stock. Moreover, they'll be required to contribute a portion of their earnings to the new affordable housing program. I happen to think this program is meritorious, but I wonder what do you think is the long run financial condition of the Federal Home Loan Banks? Will permitting credit unions and commercial banks to borrow from their window significantly help them?

Answer

The financial demands placed on the FHLBs by FIRREA will cause some individual banks, over the next few years, to have lower capital-to-asset ratios and dividend rates than they were accustomed to before FIRREA.

It is too early to tell what the impact of allowing commercial banks and credit unions to join the FHLB System will be. Enlarging the pool of potential members could result in a capital infusion into the System. However, the minimum capital stock purchase required may reduce the benefits of membership in the FHLB System and discourage some banks and credit unions from joining.

The Act's impact on the long-run financial condition of the FHLBs is unclear. Treasury will be examining this situation, as well as the condition of the FHLB System as a whole, in the GSE study mandated by FIRREA.

Question

Could the profits generated by GSEs be lessened in order to reduce the cost of mortgages to the homebuying public?

Answer

The relationship between a change in GSE profits and mortgage rates is not clear. Mortgage rates are determined by overall conditions in the financial markets and the interaction of the supply and demand for mortgage credit, while GSE profits are related to financial market conditions and the GSE's activity levels.

Over the past three years mortgage credit has increased by an average of $316.4 billion per year to a total of $3.3 trillion outstanding. The expansion in mortgage credit was bolstered by the existence of active securitized mortgage markets. Confining GSE activity levels and thus cutting profitability could have had an adverse impact on mortgage rates by restricting the supply of mortgage credit.

Question

Do you believe there is a tension between the private ownership and the public missions of certain GSEs?

Answer

The need of GSEs to provide an adequate return to their shareholders is related to the overall level of risk that they are willing to accept under certain circumstances. The Treasury study will attempt to measure both on and off balance sheet risks assumed by the GSEs.

Question

To what extent do you agree with Freddie Mac President Brendsel that Freddie Mac could remain viable under the most severe of circumstances for ten years? To what extent are other GSEs protected from adverse economic circumstances like high interest rates, severe inflation, or a prolonged recession? Could Fannie Mae withstand a stress test of the severity of the one under which Freddie Mac was tested?

Answer

The Treasury study will examine Freddie Mac's model and stress test for reasonableness and sensitivity. The study will also evaluate the credit and interest rate risks of each of the other GSEs, including applying a stress test to Fannie Mae. We have not had a chance to complete this examination, so that it would be premature to come to any conclusions at this time.

Question

Do you feel that the current level of regulation of the different GSEs is inadequate? If Congress were to act to beef up the regulation of GSEs, where should we vest the regulatory authority? Under the current general schedule, could the Federal government hire individuals with the sophisticated financial skills to oversee and second guess organizations like Fannie Mae and Freddie Mac that are at the cutting edge of the financial services industry?

Answer

The Treasury is studying the risks that are undertaken by the GSEs and the impact of the GSEs on financing the Federal debt. We have not completed our risk-assessment tasks, nor have we had an opportunity at this point to review the current structure of regulation of the GSEs. Therefore, it is too early to comment on the adequacy of the current regulatory regime or whether it should be vested in some centralized regulatory authority.

Question

What is the actual liability of the Federal government with regard to debt and mortgage-backed securities issued by Fannie Mae? Supposing that there is either a legal or moral liability of the Federal government, what would be the financial magnitude of this liability?

Answer

The Fannie Mae charter act provides that Fannie Mae obligations and interest thereon "are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof" (12 U.S.C. 1719(b)).

The Treasury study of GSEs will include financial analyses to assess the interest rate and credit risks undertaken by the GSEs. Any potential liability to the government of a problem at Fannie Mae would depend upon the magnitude of the problem, the alternatives that Fannie Mae had to deal with it without government intervention, and overall market conditions at the time.

Question

What impact would a severe decline in housing prices have on the GSEs that have a heavy involvement in housing markets?

Answer

A large across-the-board decline in housing prices would reduce homeowners' equity and likely increase default rates. Even though low loan to value ratios at Fannie Mae and Freddie Mac would cushion the impact of declining home prices, defaults could increase. In addressing credit risk, the Treasury study will examine the relationship between a severe decline in housing prices, increased default rates, and capital adequacy at affected GSEs.

Responses of Thomas H. Stanton to

Questions from Senator Donald W. Riegle, Jr.

October 31, 1989

1. What is the effect of GSEs on the health of competing financial intermediaries? Do our implicit guarantees substantially raise our risks of loss on deposit guarantees?

This question has not been adequately explored. For example, economists Patric Hendershott and James Shilling have estimated that Fannie Mae and Freddie Mac have adversely affected the mortgage interest income of thrift institutions. However, analysis is not available that would demonstrate the extent that this squeeze on thrift industry profits was a contributing factor to the huge losses suffered by the industry in the 1980's.

Indeed, a major problem may be the reverse of the one posited by the question. The implicit federal guarantee of GSEs may reduce our risks of loss from deposit guarantees by shifting risk from banks and thrifts to the GSEs. For example, as Fannie Mae and Freddie Mac securitize long-term portfolios of thrifts and other holders of home mortgages, and as Farmer Mac begins to securitize bank farm mortgage portfolios, credit risk in these banks and thrifts, backed by the deposit insurance funds, is likely to drop. The problem is that securitization merely moves that credit risk to the GSE that is guaranteeing the securities. If credit problems occur, for example because of declining real home prices or declining credit quality of agricultural mortgages, undercapitalized GSEs may find themselves unable to absorb the losses. The government would then risk loss from the implicit federal guarantee of enterprise securities, rather than through the federal deposit insurance funds.

2. How does extent of regulation and supervision of large money center banks compare with that of GSEs?

Especially in recent years, the federal government has provided for a comprehensive system of regulation and supervision of large money center banks. The federal bank regulators have a variety of enforcement tools at their disposal, including cease-and-desist orders, civil money penalties, authority to remove directors and senior managers, disapproval of dividend payments and authority to impose capital directives. They also have authority to appoint a conservator or receiver if an institution with federally-insured deposits falters or fails. A number of these powers were strengthened in the 1989 Financial Institutions Reform, Recovery, and Enforcement Act.

Since the collapse of the Farm Credit System in 1985, the Farm Credit Administration, regulator for FCS institutions, has been given many of the powers of a federal banking agency. With that exception, most of the GSE regulators, where there is one, lack comparable authority to supervise safety and soundness. Indeed, as was discussed at the hearing, the Department of Housing and Urban Development believes it lacks even the clear mandate to oversee safety and soundness, and has never used its authority to examine Fannie Mae's books and records. The largest GSEs, Fannie Mae and Freddie Mac, are not subject to binding capital requirements or even the rudiments of effective federal financial supervision.

3. Should we require SEC registration of all GSE issues?

Even more useful to help investors and the public monitor safety and soundness, would be a requirement that each GSE publish, on a quarterly basis or as material changes occur, information concerning its safety and soundness. This information should include quantifiable information on credit risk, interest rate risk and market risk, and material descriptive information concerning business and operations risk. In addition, GSEs should be required to publish, again on a quarterly basis or as material changes occur, their financial statements on a market-value basis, including a statement of market-value net worth.

4. Do we need minimum real capital standards for all GSEs?

As with any financial institution with federal credit backing, effective capital requirements serve two purposes: First, having significant shareholder capital at stake helps give management an incentive to be more prudent than if the enterprise uses a higher proportion of federally-backed money when it takes financial risks. Second, capital is the deductible portion of the federal insurance policy. If something goes wrong, a substantial cushion of capital is needed to help protect taxpayers from loss.

As are other federally-backed financial institutions, enterprises should be subject to minimum capital as well as risk-based capital standards, and those standards should be comparable to requirements imposed on the other institutions. Otherwise, the federal government risks having the financial markets use devices such as securitization of loan portfolios to shift financial risk to a place where the lowest significant capital requirements exist. Vis-a-vis thrifts and banks, that low point clearly rests today with the government sponsored enterprises.

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Responses of Thomas H. Stanton to Questions Submitted by Senator Jim Sasser

October 31, 1989

1. Is there a danger that Fannie Mae and Freddie Mac are benefitting from their government sponsorship at the expense of possible competition in mortgage financing markets? Do Fannie Mae and Freddie Mac currently have oligopoly powers in the market place? If so, what impact would these oligopoly powers have on the cost of mortgages to homeowners in the absence of broad-based, cost-cutting competition?

By definition, Fannie Mae and Freddie Mac have duopoly powers in the market place. Unlike the system for chartering national banks that imposes some barriers to entry, but generally permits any group of incorporators meeting capital and other requirements to apply for a national bank charter, the federal government has not created a system that would permit new companies to serve the market place under charters similar to those of Fannie Mae and Freddie Mac.

Some history is relevant here. The Roosevelt Administration in 1934 supported legislation to establish a national-bank-type system for chartering national mortgage associations. Under the 1934 National Housing Act, incorporators willing to provide the necessary capital and accept the benefits and limitations of a national mortgage association charter were authorized to create national mortgage associations. The Roosevelt Administration envisioned that a number of such associations would be created to serve as secondary mortgage market institutions. For a variety of reasons, especially because of the economic hesitancy after the onset of the Great Depression, but also because the final legislation failed to provide enough benefits to make a national mortgage association charter financially attractive, no such associations were ever formed. The Roosevelt Administration then turned to the Reconstruction Finance Corporation to create Fannie Mae in 1938.

The 1934 legislative model is interesting from a competitive point of view. It addressed concerns about safety and soundness with provisions for effective supervision and substantial (probably excessive) capital requirements. If it had worked, the 1934 legislation would have meant the emergence of new institutions to take advantage of the significant benefits of the more generous federal charters now available only to Fannie Mae and Freddie Mac. This would have facilitated the active competition of a number of firms to serve the mortgage market and help assure that federal charter benefits would be passed on to homebuyers.

2. What consideration are you giving to the public missions the individual GSEs have been established to serve? Is the cost of the mission worth the benefit?

No one can begin to judge whether the cost of the mission of each GSE is worth the benefit because, until enactment of the 1989 Financial Institutions Reform, Recovery, and Enforcement Act, the federal government was denied access to information essential for determining financial risk involved with GSE lending activities. The federal government has chartered a variety of institutions, including thrifts, national banks, credit unions, and GSEs, to serve commendable purposes. However commendable these purposes may be, as we have learned from the thrift industry debacle, it is axiomatic that safety and soundness must come first. A failed institution serves no public purpose.

3. Are we comparing apples and oranges when we compare Fannie Mae with a private commercial bank? Or is there significant risk imposed by the GSEs?

GSEs share many characteristics with commercial banks. Like a commercial bank, a GSE is a federal instrumentality chartered to serve a public purpose. Just as a commercial bank benefits from federal deposit insurance, a GSE uses an implicit guarantee of its debt and mortgage-backed securities to lower its cost of funds. As with commercial banks, the implicit federal backing of GSE obligations creates moral hazard, i.e., the opportunity for shareholers to benefit from increased risk-taking while taxpayers stand ready to absorb most of the losses that may arise from such risk-taking. With respect to the need for effective federal oversight of safety and soundness, when we compare banks and GSEs we are comparing apples and apples.

4. What is the long run financial condition of the Federal Home Loan Banks?

As pointed out in the testimony, one provision of FIRREA raises the special concerns about the long-term financial future of the Federal Home Loan Bank System. That is the part of Subsections 731(e) and (m) that permits Freddie Mac and Fannie Mae to make loans on the security of mortgages in direct competition with the Federal Home Loan Banks. It is likely that competition from the other two enterprises will reduce earnings of the Federal Home Loan Loan Banks in their core business.

A major policy issue that must be confronted is the value of the public purpose served today by the Federal Home Loan Bank System. This is not a small question for a financial institution that at year-end 1988 reported $175 billion of assets, making it one of the largest financial institutions in the United States.

5. Is there a tension between the private ownership and the public missions of certain GSEs?

There is always some tension between managers -- government or private -- and their public missions. For a shareholder-owned company, the law gives a very clear statement of priorities: Within the confines of an institution's federal charter, the directors of the institution have a fiduciary responsibility to the private shareholders. As Sallie Mae has told a Congressional Oversight Subcommittee: "We are a private corporation, and as such, with stockholders and bond holders, we have a fiduciary responsibility to those individuals. . . . We are not charged with subsidizing the guaranteed student loan program or subsidizing the students." Senate Committee on Labor and Human Resources, Subcommittee on Education, Arts, and Humanities, *Hearing: Oversight of Student Loan Marketing Association* (*Sallie Mae*), August 12, 1982, p. 135 (Statement of Edward A. Fox, Sallie Mae President and Chief Executive Officer).

The policy decision, whether to administer a federal credit program through a governmental agency or through a privately-owned institution, calls for considerable judgment. As has been seen in programs administered by the U.S. Department of Housing and Urban Development and the

Farmers Home Administration, improper incentives and financial problems can also occur in credit programs administered directly through a government agency.

6. To what extent are government sponsored enterprises protected from adverse economic circumstances such as high interest rates, severe inflation, or a prolonged recession? Could Fannie Mae withstand a stress test on the severity of the one under which Freddie Mac was tested?

Unfortunately, once again, the federal government has not collected sufficient information to provide an independent answer to this question. Moreover, it is not prudent merely to try to answer such a question for 1990 and 1991 and then to set the issue aside. The financial circumstances of government sponsored enterprises can change dramatically according to quality of management and market circumstances at any particular time. Therefore, it is important that the risk assessment of government sponsored enterprises, now being conducted by the Treasury Department only for the years 1990 and 1991, be made a permanent annual report. The federal government, as guarantor of over $700 billion of enterprise securities, would be seriously remiss if it did not constantly monitor the risks being taken by the private insititutions that benefit from that generous extension of credit.

7. If Congress were to beef up the regulation of government sponsored enterprises where should we vest the regulatory authority? Under the current general schedule, could the federal government hire individuals with the sophisticated skills to oversee and second guess an organization like Fannie Mae or Freddie Mac that are the cutting edge of the financial services industry?

For reasons explained in a recent article in Public Administration Review, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," by Ronald C. Moe and Thomas H. Stanton, July/August 1989, it is recommended that federal supervision of safety and soundness of government sponsored enterprises be centralized in a single agency. Such an agency could be an office within the Treasury Department similar to the Comptroller of the Currency, or an independent agency similar to the Federal Deposit Insurance Corporation. This agency should be authorized to compensate its staff at levels comparable to those of the federal bank regulators, somewhat above the usual civil service levels. Moreover, as with the OCC and FDIC and the Farm Credit Administration, the independent agency should be funded from assessments on the regulated institutions.

8. What is the actual legal liability of the federal government? Supposing that there is either a legal or moral liability of the federal government to guarantee GSE obligations, what would be the financial magnitude of this liablity?

The federal government's implicit guarantee is not a formal legal one. Indeed, a number of GSEs such as the Financing Corporation expressly disavow government backing when they issue their debt.

However, the implicit federal guarantee is extremely strong and is moral as well as practical. The federal government makes a strong statement to investors by conferring upon GSEs securities the same preferred investment status as U.S. Treasury obligations. The exemption from the usual SEC registration laws removes investor protections considered necessary for all but the most secure (i.e., federally-backed) securities. Similarly, the exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally-backed securities. Investors perceive that the federal government would not permit these exemptions from basis investor protections unless securities were extremely safe.

This represents the government's moral obligation. The government has a practical obligation as well. Over time, as the volume of outstanding enterprise obligations increases, so does the inability of the federal government to intimate that it would not stand behind this debt. When the Continental Illinois Bank failed, for example, the federal government not only stood behind FDIC-insured deposits, but also protected uninsured bank creditors and even creditors of the parent holding company. The Comptroller of the Currency told Congress of fears of a domestic and possibly international crisis if all Continental creditors were not protected. At the time the Continental Illinois national bank was a $40 billion institution, significantly smaller than Fannie Mae and Freddie Mac, the Federal Home Loan Bank System, or the Farm Credit System.

The financial magnitude of the government's contingent liability is represented by the total volume of enterprise obligations and mortgage-backed securities outstanding, today some $750 billion. The government has never calculated the actual federal contingent liability in terms of the probabilities that enterprise risk-taking will lead to claims based on the implicit federal guarantee, and the likely amount of such claims.

9. If it is true that real housing prices will decline, what impact would this have on government sponsored enterprises that have heavy involvement in housing markets?

Unfortunately, once again, the federal government is not in the position to quantify the risk exposure of the government sponsored enterprises, or even to assess the adequacy of measures taken by the government sponsored enterprises to protect themselves against such risk. For example, concern about mortgage credit quality can be addressed by requiring higher downpayment, and making loans with lower loan-to-value ratios. Mortgage seller-servicers might be more closely monitored and might be held to more stringent financial standards. At this point, the government merely has the assurances from Fannie Mae and Freddie Mac themselves that everything is fine. That is an inadequate basis on which to extend $600 billion worth of credit through the implicit guarantee of the obligations and mortgage-backed securities of the two institutions.

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